FEDERAL DEFICIT SMALLER THAN THE 1980S 4

SLEIGHT-OF-HAND BALANCES STATE BUDGETS 7

TAX WATCH 10-11

Budget&Tax News

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How Washington State Balanced Its Budget

by John Skorburg

According to the National Association of State Budget Officers, the state of Washington opened its 2003 fiscal year with a $1.6 billion deficit—less than the $2 to $3 billion deficit it was projected to have, but a substantial deficit nevertheless. Among the 50 states, Washington's budget deficit was 16th highest.

By the end of the legislative session, not only had the governor and state legislature wiped out the 2003 deficit, but a

WASHINGTON p. 16

Taxes, Education Clash in Nevada

by Chris Atkins

The state of Nevada is in the midst of a constitutional tug-of-war pitting Silver State taxpayers against the state's education bureaucracy. For the moment, the state's top court has given the edge to the bureaucracy.

Gov. Kenny Guinn

The conflict stems from the inability of Governor Kenny Guinn to secure a tax increase to pay for his school spending plan. The state constitution requires

NEVADA p. 17

Taxpayer Group Recognizes Top-Ranked Governors

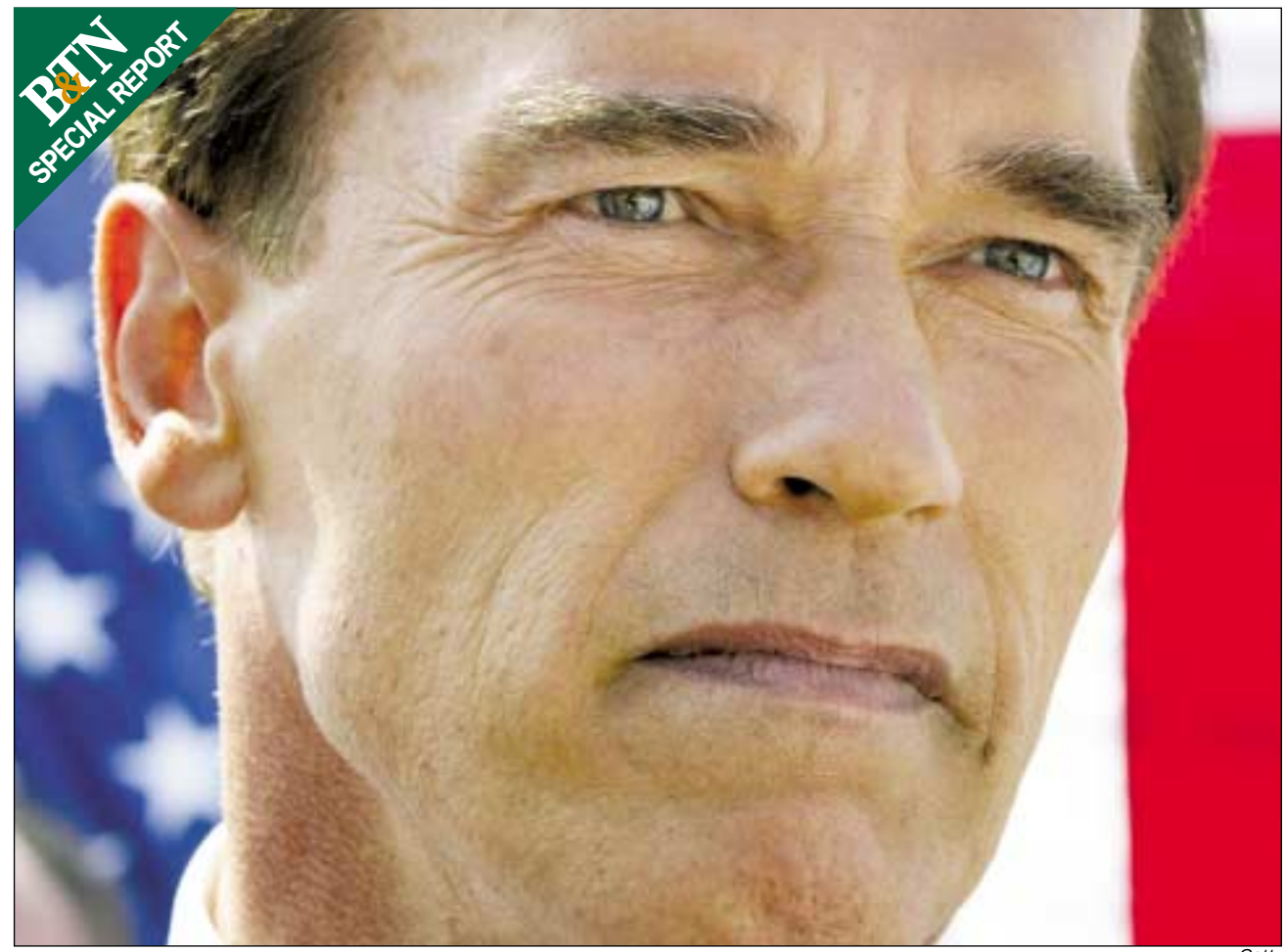
by Emily Sedgwick

Americans for Tax Reform (ATR), a Washington, DC-based taxpayer advocacy group, awarded 17 governors with high ranks this year, and seven of those were given special "Gold Star" recognition. The Gold Star governors were recognized for their work on behalf of state taxpayers and their leadership by example for the nation.

"This award is a way for ATR to thank

GOVERNORS p. 8

Schwarzenegger Faces Toxic Tax System



Getty

by Scott Hodge

California's October 7 recall election turned the eyes of the nation to the state's economy and its tax system. Governor-elect Arnold Schwarzenegger and his team face a tax system that, statistically speaking, is one of the worst in the country for business development and economic growth.

Business Tax Climate

California ranks 49th (second worst) in the Tax Foundation's State Business Tax Climate Index, which measures the impact on business of five major elements of the tax system: the percentage of income taken by all taxes, individual income tax rates, corporate income taxes, sales tax rate,

SCHWARZENEGGER p. 12

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INTERNET

House Passes Bill to Ban Internet Taxes

by Hon. Christopher Cox

Managing Editor's Note:
On September 17, 2003 the U.S. House of Representatives approved H.R. 49, the Internet Tax Non-Discrimination Act, to permanently ban Internet-only taxes. Representative Christopher Cox (R-California), chairman of the House Policy Committee and chairman of the Homeland Security Committee, released this statement following the vote.

Congressman Christopher Cox (R-California) commends his colleagues on both sides of the aisle for their approval of H.R. 49, which bans multiple and discriminatory Internet taxes.

I am proud to be the author of the 1998 Internet Tax Freedom Act, which created a national moratorium on multiple and discriminatory Internet taxes, and I'm proud to be the author of the bill approved by the House today to make this moratorium permanent. I commend my colleagues in the House for passing this important legislation.

Today, Republicans and Democrats have come together to say that no matter how we might choose to fund government services, we all agree that it would be counterproductive to create new taxes that target the Internet, which are harmful to consumers, destructive to technological innovation, and bad for our economy.

"[W]e all agree that it would be counterproductive to create new taxes that target the Internet, which are harmful to consumers, destructive to technological innovation, and bad for our economy."

Today, the great news that we share with all American consumers is that you will be fully protected from taxation no matter how you choose to access the Internet—dial-up, cable modem, DSL, satellite, wireless, or some pathway yet to be invented.

The case for taxing Internet access has never been weaker. There's no question that we all benefit from more and faster Internet connections, bringing us countless educational, commercial, and cultural opportunities. A January 2003 UCLA study reports that consumers now rank the Internet as their single most important source for information. Widespread adoption of high-speed Internet connections would add an additional $500 billion to U.S. gross domestic product in each of the next 10 years, according to a recent study.

New taxes would make Internet access even less affordable, and discourage the adoption of broadband connections. Punishing Net users with a new monthly tax on Internet access, whether dial-up or broadband, should not be anybody's idea of pro-consumer policy.

This legislation will help keep Internet access affordable. In many areas, the difference between dial-up and broadband is ten dollars a month. If ten dollars a month is already a barrier for people to embrace broadband, adding an increment on top of that is only going to keep the digital divide wide open.

Representative Christopher Cox (R-California) is chairman of the House Policy Committee and chairman of the Homeland Security Committee. He authored the 1998 Internet Tax Freedom Act.

H.R. 49—the Internet Tax Non-Discrimination Act

H.R. 49, the Internet Tax Non-Discrimination Act, makes permanent a tax moratorium first enacted in 1998 as the Internet Tax Freedom Act. The original measure expired in October 2001, and Congress approved an extension until November 2003.

After the House approved H.R. 49 on September 17, the measure was placed on the Senate calendar the following day. The full Senate is expected to take up the matter before year-end. The Senate Commerce Committee approved a nearly identical bill in July 2003.

H.R. 49 prohibits taxes on Internet access; taxation by multiple states on products purchased over the Internet; and discriminatory taxes that treat Internet purchases differently from other types of sales.

The current moratorium prohibits states from imposing multiple or discriminatory taxes on electronic usage and from imposing taxes on Internet access. The moratorium does not prohibit states from collecting either sales or use taxes on Internet purchases.

The current moratorium exempts Hawaii and local jurisdictions in New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Tennessee, Texas, Washington and Wisconsin, allowing them to continue taxing Internet access because they already had a law in place before the ban was enacted. H.R. 49 would phase out that exemption.

H.R. 49 does not address the "streamlined sales tax" plan put forward by a coalition of states seeking approval to collect sales taxes on purchases made online.

Under the current tax moratorium, the Internet is strong and growing stronger. More than 150 million people in the United States use the Internet, a number that has tripled since 1997. More than 600 million people around the world now access the Internet, more than twice the number of just two years ago.

— *J.S.*

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Higher Beer Taxes Unfair, Regressive

by Chris Kinnan

You probably didn't know this, but a staggering 44 percent of the cost of the average beer is taxes. And the situation is getting worse.

The problem is the government spending binge that's still underway in many states. A report released earlier this year by the National Conference of State Legislatures (NCSL) found that despite some budget cuts and tax increases, too many states continue to overspend for the third straight year. Twenty-seven states currently have budget shortfalls.

Failing to make much progress in curbing spending, at least 19 states are considering increases in taxes and fees, according to NCSL. So far this year, NCSL reports, six states have raised cigarette taxes and two have raised beer taxes. This is on top of an already aggressive tax regime for those legal products.

All 50 states already levy an excise tax on the sale of beer. Some cities and counties levy their own taxes as well. There's a multiplier at work, too, because most states and many local governments also impose a general sales tax, which is added to the final tab at the register.

Pennsylvania, home of Iron City, Rolling Rock, and a good number of beer drinkers, is the flashpoint for the fight over beer taxes. After all, western Pennsylvania farmers led the Whiskey Rebellion in 1794 in opposition to punitive federal taxes on whiskey stills. Fast forward to 2003, where Keystone State Governor Ed Rendell wants to raise taxes on beer, more than tripling the state tax from 8 cents to 25 cents.

In March, Congressman Phil English (R-Pennsylvania) introduced H.R. 1305, a bill to repeal the federal "luxury" tax on beer. English has the right idea— policymakers and the public should support repealing beer taxes, not raising them.

In 1990, Congress voted to raise taxes on goods like luxury automobiles, furs, jewelry, yachts, and private airplanes, and to double the federal excise tax on beer from $9 to $18 a barrel. These "luxury" tax hikes destroyed tens of thousands of jobs and nearly wiped out the U.S. boat-building industry. The 1990 tax increase also cost 60,000 people their jobs in the brewing, distributing, and beer retailing industries, according to an analysis by DRI/McGraw-Hill. Congress recognized the sheer stupidity of the luxury tax increases and has since repealed them—except for the "luxury" tax on beer.

"More than half (52 percent) of all beer is purchased by families with incomes of $45,000 or less. And now states want to increase this tax. Where is the liberal outrage?"

Beer excise taxes are unfair and regressive, hitting poorer consumers hardest. According to Citizens for Tax Justice, people whose family incomes are in the bottom 20 percent pay a tax burden from beer excise taxes five times greater than people with family incomes in the top 20 percent. More than half (52 percent) of all beer is purchased by families with incomes of $45,000 or less. And now states want to increase this tax. Where is the liberal outrage?

States and the federal government have an insatiable appetite for new spending, and they especially love to tax the working man's favorite drink: beer. It's time to give Joe Six Pack a break.

Chris Kennan is director of public affairs for Citizens for a Sound Economy.

INTERNET INFO

For more information, visit the Citizens for a Sound Economy Web site at **http://www.cse.org**.

IRS Commissioner Mark W. Everson

The U.S. Senate confirmed Mark W. Everson on May 1, 2003, as Commissioner of the Internal Revenue Service. Everson is the 46th commissioner since the agency was created in 1862. President George W. Bush appointed him to a five-year term.

The IRS commissioner presides over the nation's tax administration agency. The agency has approximately 100,000 employees and a budget of $10 billion. In 2002, the agency collected $2 trillion in tax revenue, processed 226 million tax returns, and issued $283 billion in refunds.

From August 1, 2002, until his confirmation, Everson served as deputy director for management for the Office of Management and Budget. Before becoming deputy director for management, he served as controller of the office of Federal Financial Management, also a part of OMB.

Everson also served in the Reagan administration from 1982 until 1988, holding several positions at the U.S. Information Agency and Department of Justice, where he was deputy commissioner of the Immigration and Naturalization Service.

— J.S.

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Federal Deficit Still Smaller than the 1980s

Bush budget suggests alarm over the deficit may not be justified

by Scott Hodge and John Skorburg

If current federal laws and policies do not change, the federal government will incur a total budget deficit of $374 billion in 2003 and $480 billion in 2004, the Congressional Budget Office (CBO) projected in its August and October Updates.

Although these deficits represent "record levels in dollar terms," at about 3.5 percent of gross domestic product (GDP) they are "smaller than the deficits of the mid-1980s and early 1990s relative to the size of the economy," according to CBO.

In the absence of further legislative changes, the recent surge in deficits will peak in 2004, CBO estimates. After that, annual deficits will "decline steadily" before giving way to surpluses early in the next decade (2012). During the last deficit cycle, the federal deficit as a percent of GDP peaked in 1983 at roughly 6 percent.

The President's Office of Management and Budget (OMB) generally agrees with this outlook. In its Mid-Session (2003) Review of the Budget, the OMB noted, "The deficit ... is projected to increase slightly to $475 billion in 2004."

According to these two sources, then, triple-digit deficits are indeed back, but not out of line when measured against the historical economy. This is the conclusion reached by three 2003 studies of the data from the American Farm Bureau Federation, Tax Foundation, and economist Brian Wesbury of Griffin, Kubik, Stephens & Thompson.

"No matter how the government finances its activities—by borrowing or taxing—the private sector will have fewer resources. It is the amount of spending that matters, not whether government finances that spending by borrowing."

BRIAN WESBURY
GRIFFIN, KUBIK, STEPHENS & THOMPSON

American Farm Bureau Federation

According to an Economic Analysis Team report from the American Farm Bureau Federation, "The current episode of budget deficits is not out of line when compared to the budget deficits run in the 1980s. While current deficits (2004-2008) will run at about 2.3 percent of GDP on average, only a single year from 1975 to 1995 had a deficit less than 2 percent of GDP—the rest were much higher.

"At first glance, FY2003/FY2004 budget deficits in excess of $400 billion per year are a bit unnerving," notes the report. "When placed in the perspective of measuring the deficit as a percentage of Gross Domestic Product (GDP) the figures become more palatable. In fact, over the past 50 years, the current deficit cycle in relation to the size of the economy is no worse than average."

Based on the CBO and OMB outlooks, by 2008, the deficit will be 1.4 to 1.7 percent of GDP. That would also be close to the "average deficit" of the past 50 years.

Tax Foundation

According to the Washington, DC-based Tax Foundation, the average post-WWII deficit as a percent of GDP is 1.6 percent (1946-2002). Over the entire 50 years, only eight years have been in surplus.

In the Tax Foundation report, total receipts and outlays for 2003-04, as a percent of the economy, fare well when measured against various historical periods. The budget deficit as a percent of the economy for FY04 is higher than the post WWII average, but lower than that for George Bush Sr. and Ronald Reagan.

"It is important to put the current budget proposal into historical context," note the report's authors. "To do so, it is necessary to translate current spending and revenue proposals into real terms either by adjusting for inflation or by expressing the proposal in terms of the broader economy. Looking merely at the budget in nominal terms that do not account for inflation or economic growth is misleading and inaccurate."

A table produced by the Tax Foundation compares the current budget with the post-World War II era and the past three administrations. Highlights from the Tax Foundation include:

■ The President's budget proposes spending $390.4 billion on defense-related activities in FY 2004. This amounts to 17.5 percent of all spending and 3.5 percent of GDP. This level is roughly the same as defense spending was in 1996, which amounted to 17.0 percent of all federal spending and 3.5 percent of GDP. Defense spending in 1987, the height of the Reagan build-up, was 28.1 percent of all federal spending and 6.1 percent of GDP.

■ The President's budget proposes a fiscal year 2004 budget deficit of $307.4 billion, which is 13.8 percent of all spending and 2.8 percent of GDP. This level is roughly the same as the deficit was in 1994, which amounted to 13.9 percent of all spending and 2.9 percent of GDP. Deficit spending in 1983, the highest point during the Reagan administration, was 25.7 percent of all spending and 6.0 percent of GDP.

Economist Brian Wesbury

Economist Brian Wesbury is also not alarmed by the upcoming Bush deficits; he is more concerned with unfunded liabilities that may hurt the economy the most.

"Publicly held federal debt this year is roughly $3.5 trillion, but this pales in comparison to the unfunded liabilities of Social Security and Medicare, which are now $5 trillion and $13 trillion, respectively," writes Wesbury. "Promises exceed future revenues in these two programs by $18 trillion, more than 1½ years of national income, and eight times 2002 federal government spending.

"It is this future burden that holds the potential to cause economic damage, not current budget deficits; and general fund surpluses can never be large enough to cover these liabilities."

According to Wesbury, "Dealing with this as soon as possible is absolutely essential. If you want to worry about something, make it future Social Security and Medicare spending. These are the deficits that threaten the economy."

Just two years ago, in January 2001, the Clinton OMB projected a surplus of $307 billion for 2003. But a recession that began during Clinton's last year in office, combined with the fastest growth in government spending in more than 10 years during 2002, created deficits.

"While some say tax cuts caused these deficits, they would have existed even if the 2001 Bush tax cuts had never passed. More importantly, to the extent that the tax cuts helped boost growth, deficits would have been worse," notes Wesbury.

In addition, "Despite conventional wisdom, which says that deficits boost interest rates, the financial markets are not listening and interest rates are at (close to) 40-year lows. The deficit theory suggests that government borrowing 'crowds out' private borrowing, driving up real interest rates. The idea is that tax cuts, which create deficits, will boost interest rates. On its face, this theory seems correct. But its proponents forget an important fact. That fact is that taxes also drain resources from the private sector."

Wesbury closes with, "No matter how the government finances its activities—by borrowing or taxing—the private sector will have fewer resources. It is the amount of spending that matters, not whether government finances that spending by borrowing. In fact, when taxes are used to narrow a deficit, investment incentives are reduced. Borrowing, on the other hand, is voluntary and neutral on incentives. But all of this noise about deficits becomes moot

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Deficit

Continued

if we look at the future liabilities of Social Security and Medicare."

Spending Orgy?

Like Wesbury, Congressman Ron Paul (R-Texas) is most worried about excessive federal spending.

"Has Congress responded to this new reality with spending freezes or other austerity measures? Hardly. Its response has been exactly the opposite, passing a 2003 budget that is a whopping 22 percent higher than just two years ago," says Paul.

"This rate of growth cannot be sustained unless Congress truly intends to bankrupt the federal government," Paul continues. "What's another 10 million dollars, they reason, for a pet project or favor for a lobbyist?"

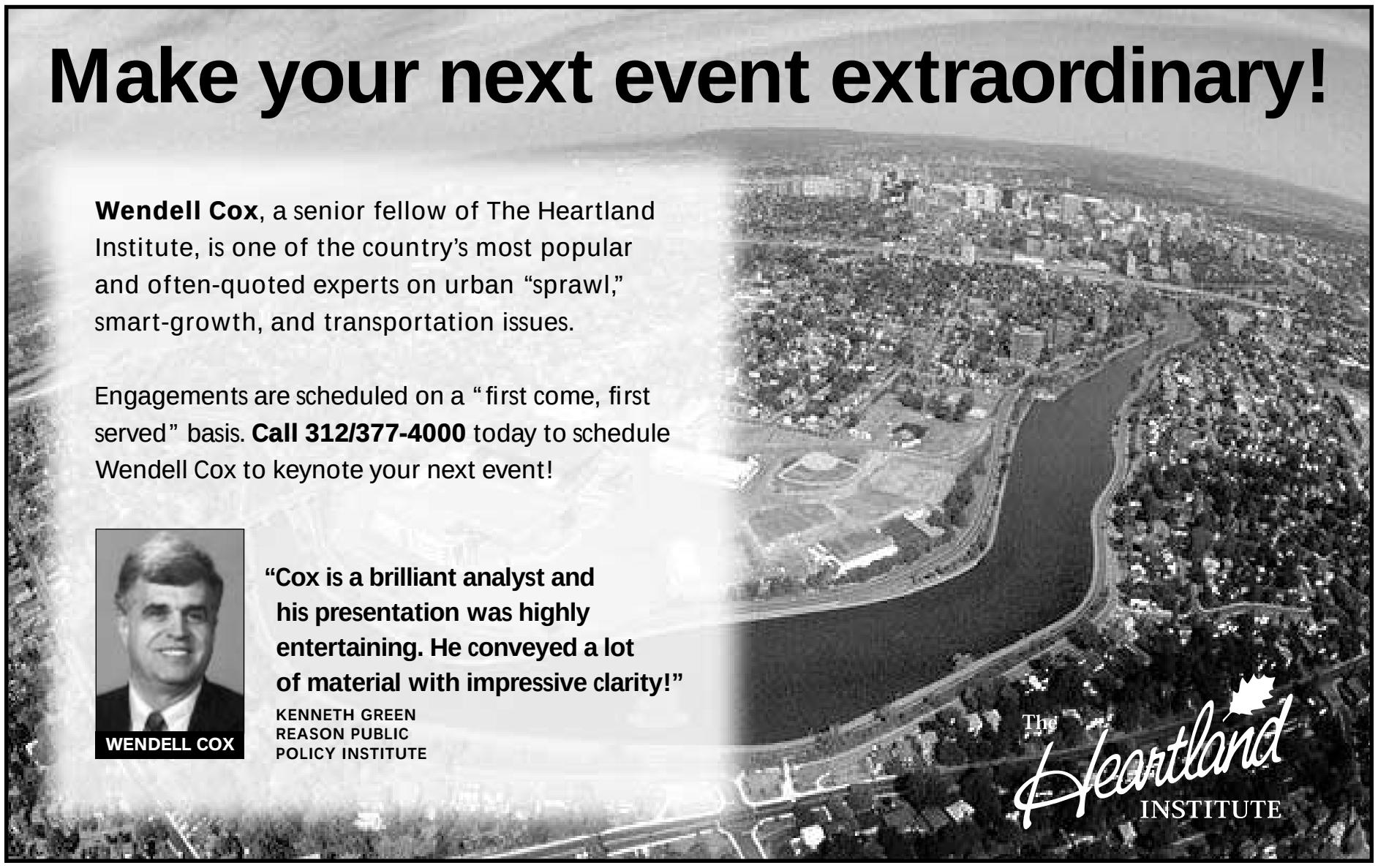
Paul concludes, "How long could your family survive if it spent 5 or 10 percent more money each and every year? All Americans must become aware of how truly unrestrained federal spending has become, and realize that voters represent the last line of defense against the complete bankruptcy of the U.S. government."

Scott Hodge is president of the Tax Foundation. His email address is **hodge@taxfoundation.org**. *John Skorburg is managing editor of* Budget & Tax News. *His email address is* **skorburg@heartland.org**.

Comparison of Bush Budget (FY2004) with Past Budget Averages

	FY2004 Proposal	Post-WWII Average (FY1946-2002)	Clinton Budgets (FY1994-2001)	G.H.W. Bush Budgets (FY1990-1993)	Reagan Budgets (FY1982-1989)
Total receipts as percent of GDP	17.0	17.9	19.4	17.7	18.0
Total outlays as percent of GDP	19.7	19.5	19.6	22.0	22.3
Deficit (-)/Surplus as percent of GDP	-2.7	-1.6	-0.1	-4.3	-4.3
Annual growth in total receipts (average % change from previous fiscal year, FY1996 $)	2.7	2.9	4.9	0.5	2.5
Annual growth in total outlays (average % change from previous fiscal year, FY1996 $)	2.2	2.3	1.5	1.9	2.7
Defense spending as a percent of total outlays	17.5	35.5	17.1	21.7	26.7
Non-defense discretionary spending as a percent of total outlays	19.2	19.4*	17.6	16.6	17.1
Net interest costs as percent of total outlays	7.9	10.5*	13.9	14.5	13.2
Other mandatory spending as a percent of total outlays	55.4	41.6*	51.4	46.2	42.9
Debt held by public at end of fiscal year as percent of GDP	36.9	44.0	43.0	46.3	36.7
Gross debt at end of fiscal year as percent of GDP	64.8	56.2	63.4	61.8	45.4

***** includes data only back to 1962, since the distinction between discretionary and mandatory began only in that year. *Source: Tax Foundation*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Alternative Minimum Tax Stalks Millions of Taxpayers

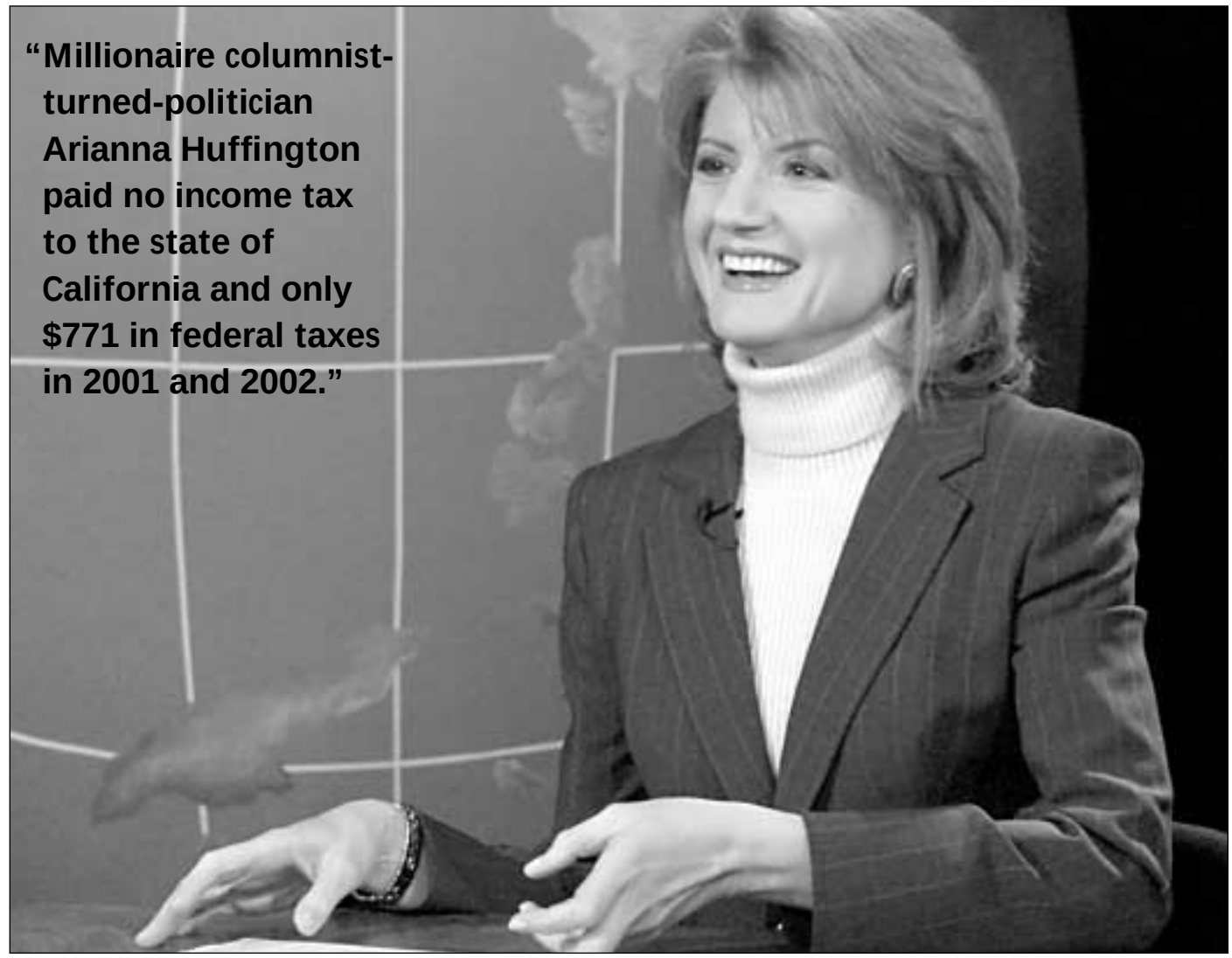
by John Berthoud

There is certainly some ironic justice in recent revelations that millionaire columnist-turned-politician Arianna Huffington paid no income tax to the state of California and only $771 in federal taxes in 2001 and 2002.

Huffington has been a leading proponent of making sure successful individuals and all corporations pay "their fair share."

For instance, in announcing her short-lived run for the California governorship, Huffington opined, "let's close the loopholes that allow corporations to avoid paying their fair share of taxes by hiding their profits in tax shelters. To do any less is a slap in the face of all the hard-working taxpayers being forced to dig deeper and deeper into their pockets so the well-connected can pad their bottom line."

Huffington claims her tax situation bears no resemblance to those she has preached about. Her company—Christabella Inc.—had large losses that offset her personal income. It is fair and right that she had only a limited tax liability.



"Millionaire columnist-turned-politician Arianna Huffington paid no income tax to the state of California and only $771 in federal taxes in 2001 and 2002."

"The logic behind the AMT is that if you don't pay 'enough' under one set of rules because of legal deductions, then you should be saddled with a second set of tax rules."

Many of Huffington's class warrior allies believe situations such as hers call for "cracking down" on those who aren't paying their "fair share." In fact, those same voices have convinced the federal government to maintain an alternate set of rules for individuals and companies who—like Huffington—may have legitimate deductions that make their tax liability negligible.

AMT Means Complexity

This second set of tax rules is called the Alternative Minimum Tax (AMT). The logic behind the AMT is that if you don't pay "enough" under one set of rules because of legal deductions, then you should be saddled with a second set of tax rules.

The AMT isn't airtight—otherwise Huffington would have had some very big tax bills during the past couple of years. Yet many other Americans were less fortunate. The AMT, originally aimed at fewer than 200 taxpayers when it was created in 1969, now threatens to become the bane of millions.

By 2010, one-third of all taxpayers in America will have to fill out a second form and comply with a second set of tax rules. Many will be people of modest incomes who don't live in $7 million Brentwood estates, as does Huffington. Most of those taxpayers, in fact, will make less than $100,000 per year. According to a U.S. Treasury Department study by economist Robert Rebelein, more than half of all families with three or more children will be subject to the AMT.

The AMT adds tremendous complexity to the tax code. Taxpayer Advocate Nina Olson calculates the AMT adds 12 hours of work to the job of preparing a single tax return. The AMT also increases the tax burden on American families and corporations. Of course, increasing the tax liabilities of corporations is an illusion. Those taxes get passed through to workers, shareholders, and consumers.

There should be one set of tax rules, and if misfortune or particular economic circumstances determine an individual or company has little or no tax liability, so be it. If people or companies are taking deductions that have little economic or social justification, the solution is not the AMT. Rather, these deductions should be the first that are jettisoned to make way for lower tax rates.

Ms. Huffington, it's OK that you didn't owe any income taxes over the past two years. Sometimes circumstances temporarily drive down the tax liabilities for corporations and individuals. Will you and your allies now admit the same should be true for all Americans?

John Berthoud is president of the 350,000-member National Taxpayers Union. His email address is **ntu@ntu.org**.

What is the AMT?

The alternative minimum tax (AMT) is an extra tax system for individuals, joint filers, partnerships, and corporations deemed by the federal government to have too many deductions or credits. Those reporting income of more than $75,000 a year are advised to fill out Form 6251 to check for possible AMT obligations. The AMT is an extremely costly, sometimes confusing, and very inefficient tax.

A Complicated Tax

The best way to understand the AMT is to view it as a separate tax system. It has its own set of tax rates and its own rules for deductions. It is less generous than the regular tax rules. The only way to tell if additional tax is owed is by filling out the forms (essentially a second time) or by being audited by the Internal Revenue Service (IRS). If it turns out more tax is owed based on the AMT calculations, additional taxes—plus any interest or penalty the IRS is legally allowed to charge— would be due from the taxpayer.

History of the AMT

The AMT has its roots in a minimum income tax enacted by Congress in 1969. At that time, 155 individuals with adjusted gross incomes of more than $200,000 had paid no income tax on their 1967 returns. The minimum tax was an "add on" of 10 percent of adjusted gross income. The number of individuals with adjusted gross incomes of more than $200,000 who paid no income tax rose to 244 taxpayers by 1974, so in 1976 Congress raised the minimum tax to 15 percent.

In 1978, Congress became concerned that the minimum tax was hampering capital formation. The minimum tax was thus changed to exclude capital gains, but the AMT was adopted to apply to capital gains for certain taxpayers.

Bottom Line

The compliance burden for the AMT can be high, and this tax is not known for either economic efficiency or tax fairness. While the AMT was originally intended to strike only the super-wealthy, it has now become known as the stealth tax: It sneaks up on many unsuspecting taxpayers. It is becoming one of the most dreaded (and complicated) provisions in the tax code.

—American Farm Bureau Federation

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Tax Officials Use Sleight-of-Hand to Help Balance State Budgets

by Jason White

In an effort to avoid cutting programs and raising taxes, officials in a handful of cash-strapped states used bureaucratic sleight-of-hand to shift revenue into fiscal year 2004 by moving forward the date on which tax payments are due.

Called a "revenue acceleration," this controversial accounting technique was employed by six states—Georgia, Illinois, Kansas, Maryland, Minnesota, and Oklahoma—to the tune of more than $300 million this year, according to the National Conference of State Legislatures (NCSL).

Although not large in the context of total state budget deficits—which were estimated at more than $70 billion in fiscal year 2004—this dollar amount can make the difference between a balanced budget and one that requires new taxes or program cuts, budget officials said.

"We get a one-time shot of $180 million and that allows us to get through this budget year without deeper cuts than what already have to be done and without increasing taxes," said Kansas budget director Duane Goossen.

"It's not only bad policy. It's kind of a nightmare for the people that have to do it. Businesses have to estimate the revenues and collect before the money is in hand."
DUANE BENSON
COALITION OF MINNESOTA BUSINESSES

Kansas nets its one-time shot by moving property tax payments from July 2004 to June 2004, the last month in fiscal year 2004. Because these tax payments are usually made twice a year—once in July and once in January—the move will enable Kansas to receive three property tax payments this fiscal year, with the payments coming in July 2003 and January and June 2004. The state made the change permanent.

"The state has used just about every tool in the budget tool box—we cut budgets, we raised taxes a year ago, we used balances and now, this year, we're also using one of these accelerators. It's one piece of a much larger solution," Goossen said.

Minnesota has been collecting sales taxes at an accelerated clip for more than a decade, despite repeated attempts to return to a more normal schedule. This year, the state increased the rate of collection to raise more money in fiscal year 2004 than the state would have received under the already-accelerated schedule.

"The sales tax that businesses would normally pay in July they pay in June. We're going to force ourselves to undo this someday, because we know it's not a good fiscal management deal. It's something that allows the state to live beyond its means and not face tougher choices," said Minnesota budget director Peggy Ingison.

Duane Benson, executive director of the Coalition of Minnesota Businesses, said his organization has long opposed the accelerated sales tax and will fight for its removal in the future.

"It's been a cycle in Minnesota, where when the revenues get tight they tend to want to collect revenue in advance, to accelerate it. We've always felt that that's bad accounting. It's another one of those gimmicks that prolongs the obvious problem," Benson said.

He added that this creates administrative headaches for the state's businesses.

"It's not only bad policy. It's kind of a nightmare for the people that have to do it. Businesses have to estimate the revenues and collect before the money is in hand," Benson said.

Until this year, Minnesota businesses had been required to pay 75 percent of their June sales tax in the month of June and 25 percent in July. In most states, businesses do not have to pay sales taxes at all until the month after they are collected. To garner additional revenue in fiscal year 2004, Minnesota lawmakers raised this year's June rate to 85 percent.

"Businesses are required to pay us ahead of the time that they actually collect the tax. We're taking money from them that they haven't yet collected on our behalf," Ingison said.

Through this action, Minnesota gained an additional $20.6 million in fiscal year 2004. It made another $17.1 million by doing the same with cigarette, tobacco, and alcohol taxes. A change to the state's property tax collection garnered an additional $14.7 million in this year.

Georgia lawmakers raised an additional $130 million this year by shortening the period during which employers must pay the taxes they withhold from employee paychecks.

"From time to time it has come up as something in a policy bank that could be done if the state were under fiscal stress. So we tapped the policy bank, I guess you could say," said Henry Thomassen, economic advisor to Gov. Sonny Perdue (R).

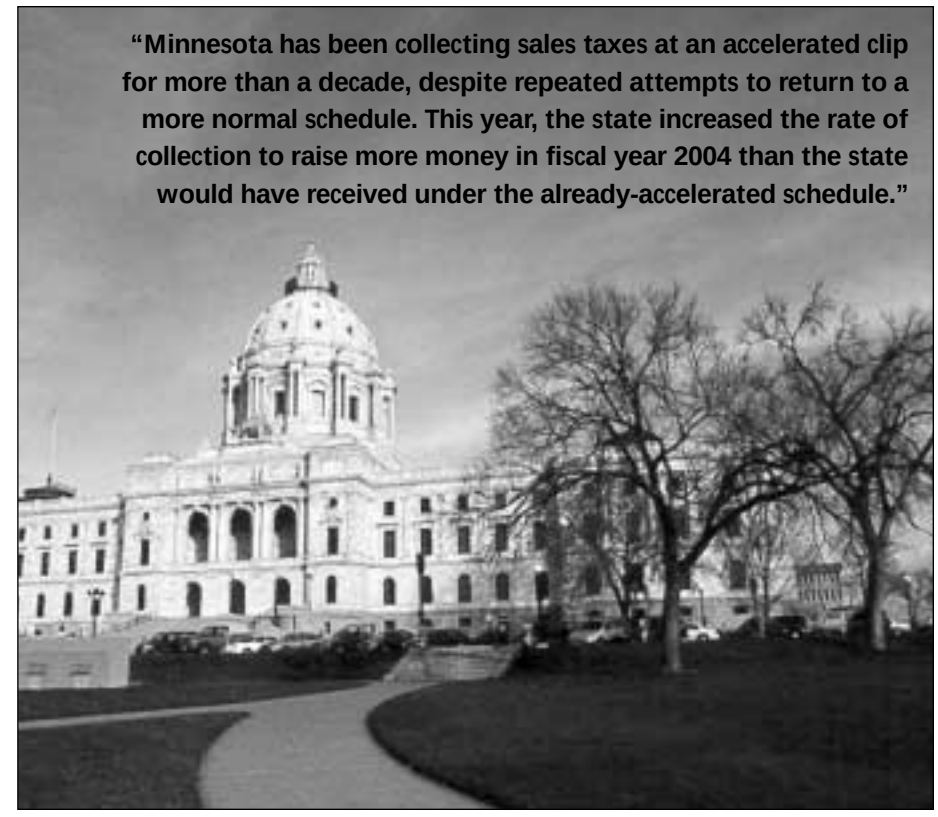
Thomassen said the move to a shorter period brings the state in line with federal regulations. He said the longer period had been allowed as a boon to Georgia businesses.

"By being able to hold money for longer periods, corporations had the opportunity to pay their bills earlier or collect interest on the money they owed to the state," Thomassen said.

Despite the fact that the shorter period could disrupt Georgia businesses, Thomassen said there was little opposition to the change.

"There seemed to be very little sentiment against the shift. Whether that sentiment will show up after the provision has been in effect for a while, I don't know. The political noise sometimes develops one or two years after a change, as businesses come to recognize what has happened," he said.

Other states accelerating revenue collections include: Illinois, which raised $50 million this year by accelerating tobacco tax collections; Maryland, which garnered $6.5 million by requiring more frequent payroll tax payments; and Oklahoma, which added $14.7 million by accelerating sales tax collections, according to NCSL.


"Minnesota has been collecting sales taxes at an accelerated clip for more than a decade, despite repeated attempts to return to a more normal schedule. This year, the state increased the rate of collection to raise more money in fiscal year 2004 than the state would have received under the already-accelerated schedule."

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Governors

Continued from page 1

some governors and show the others that they, too, can earn an award—and here's how to do it," commented Grover Norquist, president of ATR.

ATR's 2003 Gold Star governors are Bill Owens (R-Colorado), Jeb Bush (R-Florida), Linda Lingle (R-Hawaii), Tim Pawlenty (R-Minnesota), Craig Benson (R-New Hampshire), Don Carcieri (R-Rhode Island), Phil Bredeson (D-Tennessee), and Rick Perry (R-Texas).

The additional 10 top-ranked governors are the recently deceased Frank O'Bannon (D-Indiana), Mike Foster (R-Louisiana), John Baldacci (D-Maine), Mitt Romney (R-Massachusetts), Jennifer Granholm (D-Michigan), Ronnie Musgrove (D-Mississippi), Brad Henry (D-Oklahoma), James Douglas (R-Vermont), and Dave Freudenthal (D-Wyoming).

Gold Stars and Number Ones

ATR ranked governors on a scale of 1 (best) to 3 (worst). Those who have worked to pass budgets without tax increases earned a rank of 1. Signing a budget that included tax increases earned a governor a rank of 2, and actively working to pass and sign tax increases earned a rank of 3.

The top-ranked governors were also considered for Gold Star status, which recognizes their additional, proactive efforts to implement policies that benefit taxpayers, such as cutting taxes and spending. The Gold Star governors will receive lapel pins—"a little something to wear to the NGA [National Governors' Association] Annual Meeting," commented Norquist.

Among Gold Star governors, all except Bredesen are Republicans. "Republicans are better at cutting taxes and spending," said Norquist. "Sometimes Democrats will help us by opposing increases, but it's the rare Democrat who will actively work to cut taxes and spending."

Among the 10 governors who earned a rank of 1 but did not receive Gold Star recognition, seven are Democrats.

Pledge Signers Come Through

ATR paid careful attention to the actions of governors and state legislators during the 2003 legislative season, beginning in January. After the 2002 elections, many lawmakers were new to state capitols, and many had signed ATR's Taxpayer Protection Pledge promising to "oppose and vote against any and all tax increases."

Several governors-elect signed the Pledge, while others made verbal promises to the taxpayers in their states to oppose tax increases. Pledge-signer Bill Owens of Colorado fulfilled his promise by instituting a voucher program for grade school children and bringing greater efficiency to state-managed agencies, including the Colorado Medicaid program. Florida governor Jeb Bush fought for—and achieved—medical malpractice reform through four special sessions. Both Owens and Bush worked hard throughout the year to implement policies that benefit taxpayers, free enterprise, and economic prosperity—policies that qualified them for ATR's Gold Star award.

Pro-Taxpayer Governors

Bill Owens (R-Colorado)

Jeb Bush (R-Florida)

Linda Lingle (R-Hawaii)

Tim Pawlenty (R-Minnesota)

Phil Bredeson (D-Tennessee)

Rick Perry (R-Texas)

Craig Benson (R-New Hampshire)

Don Carcieri (R-Rhode Island)

Perry Stars in Texas

Another governor to earn a Gold Star, Rick Perry of Texas, worked with his state's legislature to close a $10 billion two-year budget shortfall without increasing taxes. Using tax increases to solve Texas's budget shortfall would have meant a tax increase of $1,000 per year for an average family of four.

Instead, Perry worked to pass and eventually signed a budget that cuts spending for the first time in Texas since World War II. Despite contentious debate about redistricting—over which the entire Democratic contingent of the legislature departed for Oklahoma on May 12 in protest—Perry succeeded in fulfilling his promise to taxpayers.

"This award is a way for ATR to thank some governors and show the others that they, too, can earn an award—and here's how to do it."

GROVER NORQUIST, PRESIDENT AMERICANS FOR TAX REFORM

Perry vetoed $81.1 million in spending and signed a budget that reduces overall spending from $60.7 billion in the previous year to $58.1 billion this fiscal year.

Throughout the budget negotiation process this spring, Perry also worked to reform medical malpractice tort law, joining Jeb Bush and other lawmakers across the nation in an effort to make medical services more affordable by reducing the expense of malpractice insurance for physicians. The more affordable medical services become, the less taxpayers will have to pay for government health care programs, which typically consume the lion's share of state resources and spending increases.

"The pursuit of tort reform is unquestionably one of a taxpayer-friendly lawmaker's top priorities," remarked Norquist. "Successful implementation of tort reform, in addition to working to pass a taxpayer-friendly budget, would definitely earn a governor a Gold Star."

Lingle, Carcieri, and Benson Use Veto Power

Other actions taken by Gold Star governors included using the veto power to cut spending, a power that Perry and other governors, including Linda Lingle of Hawaii, used successfully to rein in spending. By vetoing 50 spending bills this spring, Lingle set a new record in Hawaii for the most vetoes by a governor in a single session.

Among the measures Lingle vetoed was a long-term care tax that would have affected some of Hawaii's most vulnerable taxpayers. Instead, she worked to pass a long-term care tax credit to help those taxpayers afford the cost of care. Lingle also supported a tax cut that would increase the standard deduction for Hawaiian taxpayers when they file their state tax returns.

Governor Don Carcieri of Rhode Island used his veto pen in July, but to no avail; his veto was overridden by the state legislature, and a 6.3 percent spending increase and nearly $40 million in tax increases, including a cigarette tax increase, were returned to this year's budget. ATR awarded Carcieri with a Gold Star for working to cut spending and eliminate tax increases for his state's budget, even though he was ultimately unsuccessful.

Governor Craig Benson of New Hampshire used his veto pen successfully on June 26, 2003 by vetoing the legislature's $8.8 billion budget, which he said increased spending enough to make future tax increases likely. As a Taxpayer Protection Pledge signer, Benson said he felt duty-bound to veto the budget.

"We sent a shock wave through the system that said we are not going ... to live beyond our means," Benson commented to local press after his veto. "Taxpayers really did win today."

Benson also promised to pass executive orders to reduce state spending during the interim session after his veto, to reduce even further the likelihood that legislators will try to increase taxes.

Rewarding Good Behavior

ATR's gubernatorial ranking system and Gold Star recognition are intended to reward governors for taxpayer-friendly policies that reduce the burden of government and encourage free enterprise and economic growth. By rewarding good behavior, ATR hopes to encourage other governors to behave in similar ways.

"We sincerely encourage every governor to earn a Gold Star from ATR next year," said Norquist. "We're more than happy to give them out to the governors who've earned them."

Emily Sedgwick is staff writer for Americans for Tax Reform. Her email address is **esedgwick@atr.org**.

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State Deficits Remain High While Taxes Surge

by John Skorburg

Last year's elections produced nearly two dozen new governors—the largest turnover in years. But they didn't have long to celebrate their victories. Their first day on the job coincided with one of the most pressing state fiscal crises in decades, continuing into 2003.

The latest budget figures released by ALEC show little improvement. California's $31.4 billion deficit leads the nation. Combined, the top 10 states are at least $70 billion in debt. Total state budget deficits for fiscal years 2003-04 are now approaching $90 billion nationwide, with deficits over $80 billion in 2004 alone. According to ALEC, it's time for each state to "own up to its debts and evaluate the budgetary process."

"These (deficit) figures are simply staggering," said Michael Flynn, ALEC's director of policy and legislation. "But what's more alarming is that few states have yet to responsibly address this self-inflicted crisis, a decade in the making, which finally hit home well over a year ago."

According to the American Legislative Exchange Council (ALEC), "state tax increases surged by 48 percent in the first half of 2003, increasing from $8.8 billion in 2002 to a staggering $13.1 billion total in 2003."

"Tax increases are the wrong answer to state budget woes," said Chris Atkins, ALEC's director of tax and fiscal policy. "It's instructive to remember the recent past: States embracing major tax hikes to close budget gaps during the early 1990s subsequently recovered more slowly from economic recession. Not only did the tax increases retard job, income, and economic growth, but they also perpetuated state budget deficits longer than states that did not raise taxes."

According to the ALEC Mid-Term 2003 report, the current state budget climate reveals four trends:

■ Tax increases are getting bigger. In 2002, 21 states raised taxes by a total of $8.8 billion. In 2003, 20 states have raised taxes by $13.1 billion—an increase of 48 percent. Half the states that raised taxes in 2003 also raised taxes in 2002: Connecticut, Illinois, Maryland, Nebraska, New Jersey, New York, North Carolina, Ohio, and Utah.

■ States are relying more heavily on borrowing to balance their budgets. Total state borrowing in FY 2002, including general obligation, special revenue, and tobacco settlement bonding, was $30.2 billion. In FY 2003, that figure jumped to almost $68 billion, an increase of 125 percent.

■ Spending is increasing, despite tax hikes and borrowing. States cut more than $8 billion from their projected FY 2003 budgets this year. But lowering projected spending is not the same thing as cutting spending. Total spending by state governments in 2003 will be more than $11 billion higher than spending in 2002.

■ Cigarette taxes were utilized more frequently in 2002. Twenty states raised cigarette taxes in 2002 and another 12 did so in 2003. States continued to use tobacco settlement funds to shore up state budget deficits. Several state attorneys general even intervened—on the tobacco industry's behalf—in an Illinois case that threatened to make several tobacco companies insolvent. Asked ALEC, "Could it be any clearer that the states are hooked on tobacco money?"

Source: ALEC Budget Deficit Chart 2003/04

"In the 2002 sessions," reports ALEC, "many lawmakers gave approval to short-term solutions—like tobacco settlement securitization, general borrowing, and accounting tricks—designed only to erase budget deficits in the short term."

"The states were essentially betting that an economic recovery would yield higher tax revenues in the near future, allowing them to maintain current levels of spending," said Atkins. "The economy betrayed state lawmakers, however, and the short-term solutions adopted in 2002 proved even more disastrous to state budgets in 2003. Unfortunately, lawmakers took the same wager in 2003, voting for even more taxes and borrowing."

The liberal-leaning National Conference of State Legislatures (NCSL) attempted to put a more favorable spin on a dismal situation. In its mid-year update NCSL noted, "the states that have balanced their budgets amid this fiscal crisis—the worst in decades—have done so largely without relying heavily on broad tax hikes."

"Raising taxes or clamoring for a federal bailout is not the answer, and in fact will only perpetuate and deepen the current fiscal crisis," said ALEC's Flynn. "What's required is a candid and sober evaluation of each state's medium and long-term costs of operating government. It's only by reducing the size and scope of government in strategic and imaginative ways that each state finds a way out of its woes."

ALEC is the nation's largest bipartisan, individual membership organization of state legislators, with more than 2,400 legislator members from all 50 states.

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How to Cut State Spending

Facing record budget deficits and taxpayer opposition to higher taxes, many state legislators are turning for help to a 2002 report from the American Legislative Exchange Council and Manhattan Institute for Policy Research.

Show Me the Money: Budget-Cutting Strategies for Cash-Strapped States is a comprehensive evaluation of state budgets, offering 10 strategies for cutting state budget deficits, including short-, medium-, and long-term plans for reducing the cost of government.

Written by William Eggers, a Manhattan Institute senior fellow, the report offers 10 strategies and many specific recommendations to:

▷ reduce workforce costs
▷ impose broad-based spending cuts
▷ reform entitlement programs
▷ sell or lease government assets
▷ introduce competition in service delivery
▷ eliminate poorly performing programs
▷ reward employees for saving money
▷ reduce duplication and overlap
▷ use technology to slash overhead
▷ create cost-cutting brigades.

The ALEC study cites research by the National Conference of State Legislatures on how states closed budget gaps for their FY 2003 budgets: cutting spending (26), tapping state funds (23), using tobacco settlement funds (16), increasing taxes (16), tapping rainy day funds (12), and raising fees (10).

Examples of specific actions noted in the ALEC study include: cutting higher education spending (16 states), cutting corrections (14 states), tapping state funds (New York, Pennsylvania, Virginia), tobacco money (Pennsylvania, New Jersey), increases in taxes (Indiana, New Jersey, Pennsylvania, Tennessee), rainy day funds (Alaska, Ohio), and raising fees (Rhode Island, Virginia, Vermont).

"It is important to remember that no matter how successful state governments are in employing short-term measures to close deficits, the seed of fiscal crisis will remain. Only by fundamentally restructuring government will state policy makers be able to contain spending growth and return accountability to state finance," notes the ALEC report. "The ten strategies will help states do both."

INTERNET INFO

The full text of *Show Me the Money* is available through *PolicyBot*. Point your Web browser to **http://www.heartland.org**, click on the *PolicyBot* button, and search for document **#11130**, or call the American Legislative Exchange Council at 202/466-3800.

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TAX WATCH

Alabama Voters Defeat Tax Hike Plan

by John Skorburg and Max Pappas

By a 68 to 32 percent margin, Alabama voters overwhelmingly rejected Governor Bob Riley's $1.2 billion tax increase plan in a September 9 referendum.

Less than one year after he took office, Riley's attempt to overhaul the tax system in order to fill a hole in the state budget and reform the state's education finance system was snubbed by voters. The governor was reported to be "upbeat" about the results and "promising to shrink government spending and rebuild trust."

Grover Norquist, whose DC pro-taxpayer group Americans for Tax Reform (ATR) opposed Riley's plan, said, "Governor Riley is going to serve as a bad example" for other governors considering tax hikes instead of spending constraint, Norquist told CNN. "Years from now, little baby Republican governors will be told scary stories late at night, around the campfire, about the sad fate of governors like Riley who steal a billion dollars from their people."

"According to [Citizens for a Sound Economy] the tax hike would have cost Alabama $600 per working person."

Alabama Governor Bob Riley's attempt to overhaul the tax system in order to fill a hole in the state budget and reform the state's education finance system was snubbed by voters.

Ironically, *Governing* magazine earlier had named Riley its "Public Official of the Year."

Because the Riley plan was rejected by a wide margin by voters from every demographic group in Alabama, "This probably helps to secure the cut-and-balance approach to the current state budget problems rather than the raise-and spend," noted Larry Sabato, director of the University of Virginia's Center for Politics.

Economic Impact Statement

In the weeks before the Alabama vote, Citizens for a Sound Economy, a Washington, DC-headquartered grassroots lobbying group, released a study documenting how Riley's $1.2 billion tax increase plan would cost Alabama jobs, investment, and income.

According to CSE calculations, the tax hike would have cost every working person in Alabama $600 per year. The increases would have been felt by every Alabaman: homeowners, farmers, business owners, workers, vehicle owners, corporations, and those buying or refinancing real estate. CSE cited a Beacon Hill Institute study, "Tax Changes in Alabama: The Economic Consequences," which concluded higher taxes would cost Alabama 24,000 jobs and an annual loss of $331 million in investment and $2.3 billion in disposable income.

"This report shows that these tax increases would be so harmful to Alabama and its citizens," noted former House Majority Leader Dick Armey, co-chairman of CSE. "Alabamians are smart and they will vote this plan down and then the elected leaders of the state will have to find ways to cut spending."

Proponents of the Riley plan argued Alabama needed the $1.2 billion tax increase to cover a $675 million budget deficit and boost spending on the state's public schools. But CSE found spending in 2003 was $980 million higher than in 2002—a spending increase, in just one year, larger than the budget gap. CSE concluded spending cuts—rather than the largest tax increase in Alabama's history—would be a better way to address the state's budget woes.

John Skorburg is managing editor of Budget & Tax News. *His email address is* **skorburg@heartland.org**. *Max Pappas is a policy analyst for Citizens for a Sound Economy. His email address is* **mpappas@cse.org**.

INTERNET INFO

"Higher Taxes Would Harm Alabama," the 17-page CSE report released in August 2003, is available at **http://www.votenosept9.com** or on the CSE Web site at **http://www.cse.org/alabama/AlabamaReport.pdf**.

The Beacon Hill Institute study, "Tax Changes in Alabama: The Economic Consequences," is also available on the CSE Web site, at **http://www.cse.org/informed/issues_template.php/1523.htm?isitsearch=1&search1=alabama**

Wisconsin City Rejects Property Tax Hike

by John Skorburg

Voters in Baraboo, Wisconsin, a small town with a population of roughly 11,000 located in south central Wisconsin, overwhelmingly rejected a referendum on September 9 that would have increased local property taxes in order to give the school district a funding increase of $7.5 million over three years.

"Is there really a tax revolt going on in Wisconsin? Up until recently, I wasn't so sure," notes State Rep. Frank Lasee (R-Green Bay) in a recent report. "Yes, we appeared to have overwhelming popular support for the statewide property tax freeze—nearly 90 percent of calls to the Legislative Hotline were in favor. But 90 percent of hotline calls is still a very small minority of the whole state."

Against the Odds

According to Lasee, the Baraboo referendum is an important sign of the times. Nothing else was on the September 9 ballot—no other election to help draw voters to the polls. And Baraboo isn't especially known for high voter turnout generally. Low voter turnout tends to mean success for a school tax increase, Lasee notes, because the pro-referendum side, led by teacher unions, is better organized.

Frank Lasee

Lasee also doubted whether popular support for the statewide property tax freeze would extend to a school tax referendum in Baraboo. "Citizen frustration, activism, and organization over last year's pension scandal seemed to spill over to help elect an Assembly candidate who campaigned solely on his support for the freeze," Lasee notes. "But there seemed to be little evidence that this activism extended much outside Milwaukee and Waukesha."

Moreover, the Baraboo area isn't exactly a hotbed of conservative voters, Lasee notes. Both the city and the county went decisively for Democrats Jim Doyle (governor) and Tammy Baldwin (congresswoman) last year, and for Al Gore in 2000.

In the days just before the Baraboo vote, according to Lasee, voters appeared evenly split. Each side had a few yard signs and handed out pamphlets. Letters to the editor ran slightly against the referendum, but the local paper editorialized in favor of it, twice.

"Given all that," Lasee says, "one might expect the result to be a blowout."

Revolt Underway?

It was—but not in the direction Lasee and others expected. Voters rejected the measure by a 78 to 22 percent margin.

Nearly 5,000 votes were cast—more than in any election over the past five years with the exceptions of last year's gubernatorial election and the 2000 Presidential election. The state's April 2003 referendum for a constitutional amendment guaranteeing Wisconsin residents the right to hunt and fish drew only 3,000 Baraboo-area votes.

"Perhaps there really is a taxpayer revolt," Lasee concludes. "Big turnout, and a blowout defeat for what should have been, given the conditions, a successful referendum." That's evidence the tax revolt is real, says Lasee, and that it extends well beyond Milwaukee's borders. It should serve as a morale boost for Wisconsin's tax revolutionaries: "You're not alone," says Lasee.

"This referendum has to serve as a healthy reminder to all of our local, state, and federal elected officials: The taxpayers have had enough. Find another way."

John Skorburg is managing editor of Budget & Tax News. *His email address is* **skorburg@heartland.org**.

INTERNET INFO

Rep. Frank Lasee issues a weekly email report, "Lasee's Notes," covering events in the Wisconsin state legislature and statewide. To subscribe, send an email to **laseesnotes@yahoo.com**.

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Seattle Voters Say NO to Latte Tax

by John Skorburg

Voters in Seattle, Washington rejected a 10 cent per cup tax on upscale coffee—by a resounding 68-32 margin—on September 16.

In Seattle, known as the "coffee capital of the world," some 600,000 residents consume 200,000 cups of lattes per day at local establishments. Tax proponents hoped the "dime per cup" tax would raise up to $7 million per year, which local government officials said would be spent on extra public school programs for low-income families.

"We do not need another tax, especially one that unfairly taxes one product for the sake of funding a program that has nothing to do with it. Tax espresso today—what would be next?"

GREATER SEATTLE CHAMBER OF COMMERCE

Calling the latte tax proposal, I-77, "a noble but ill-conceived measure [that] should be rejected by Seattle voters," the Municipal League publicly opposed the referendum. The list of opponents was in fact long, including the Greater Seattle Chamber of Commerce; Washington Restaurant Association; former mayors Charles Royer, Norm Rice, and Wes Uhlman; State Representative Helen Sommers; the Young Democrats; and many other business, government, and community leaders. All saw I-77 as "setting a dangerous precedent for tax policy and a flawed mechanism for funding important childcare services."

"We've been working hard to strengthen our economy and improve Seattle's business climate. We do not need another tax, especially one that unfairly taxes one product for the sake of funding a program that has nothing to do with it. Tax espresso today—what would be next?" asked the Chamber in a news release.

Seattle's Families & Education levy, already in place to support children's programs in the city, will be up for renewal next year. Seattle taxpayers currently fund 11 different child care programs.

John Skorburg is managing editor of Budget & Tax News. *His email address is* **skorburg@heartland.org**.

Streamlined Sales Tax Stumbles in Kansas

by John Skorburg

Kansas retailers will get a reprieve from the provisions of a new sales tax law as a result of a "grace period" issued by Kansas Governor Kathleen Sebelius.

Sebelius announced the six-month reprieve in July and restated it in September, responding to concerns raised by the Kansas Chamber of Commerce and echoed by Senate President Dave Kerr and Speaker of the House Doug Mays.

In July, Sebelius announced the Department of Revenue would take a "relaxed" approach toward enforcing the terms of the Streamlined Sales and Use Tax Agreement Conformity Act, passed by the Kansas legislature before the close of its 2003 session. Sebelius promised the state "would hold retailers harmless for any sanctions until at least the end of 2003."

Multi-State Agreement

More than 7,000 units of government, including all but five states, levy sales and use taxes. The patchwork of state and local sales and use taxes is complex, and a business that sells in more than one jurisdiction must keep track of the tax laws in each jurisdiction.

In an effort to respond to that complexity, representatives of 33 states and the District of Columbia voted in November 2002 to approve a multi-state agreement to establish a single, uniform system for administering and collecting sales taxes on nearly $3.5 trillion in retail transactions annually.

The Streamlined Sales and Use Tax Agreement (SSUTA) will go into effect once 10 state legislatures have modified their state sales tax laws to comply, provided 20 percent of people who pay sales taxes live in those 10 states. Additional states can join the agreement at any time with the approval of those that have already signed on. The Kansas legislature's approval of the Streamlined Sales and Use Tax Agreement Conformity Act communicated its intent to participate in the compact.

The SSUTA promises businesses new tools, such as approved software, to help them collect the taxes. Under the agreement, businesses would deal with a single state entity, which would distribute the share of taxes due to counties, cities, and local taxing jurisdictions.

The SSUTA also includes a provision opponents say will create new, onerous record-keeping and collection burdens: The agreement applies not only to Main Street retailers, but to Internet sellers as well.

Mixed Response

Businesses in Kansas were the first to complain to state elected officials and get relief in the form of delayed implementation of the new rules.

Kansas Chamber President and CEO Lew Ebert said, "This was a classic case of businesses being burdened by new state regulations, our members telling us about the problem, and the Chamber taking the problem to the state bureaucracy and getting something done about it."

Ebert added, "State government regulators are in their offices everyday, making decisions that impact how business is done in this state. When those Department of Revenue bulletins started arriving at retailers, our members literally lit up our lines of communications."

"Thirty-three states and the District of Columbia have decided it's time to come up with a uniform system to simplify collecting the taxes. That could create opportunities as well as challenges for farmers and ranchers," said Pat Wolff, senior lobbyist for the American Farm Bureau Federation.

"When a cantaloupe is cut in half, put on a plate and sold with a fork and napkin, it is not food. Instead, it's 'prepared food' in certain states where that definition makes it subject to sales taxes. In other states, the cantaloupe may be taxed regardless of whether it's 'prepared.'

"The pennies' difference may not be a big deal to consumers," continued Wolff. "But if you're in the business of selling cantaloupe, you need to know whether, and how much, it's taxed in your state and perhaps others."

Even if approved by the requisite states, the SSUTA faces legal obstacles, particularly because of the Internet sales tax provision. The U.S. Supreme Court ruled in the *Quill* decision in 1992 states may not require out-of-state retailers to collect and remit sales taxes if the retailer does not have a substantial physical presence in the state. The SSUTA ignores that "nexus" requirement, and thus would require congressional approval before states could implement the online sales tax regime.

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INTERNET INFO

The full text of the 70-page Streamlined Sales and Use Tax Agreement, adopted November 12, 2002, is available through *PolicyBot*. Point your Web browser to **http://www.heartland.org**, click on the *PolicyBot* button, and search for document #**13336**.

More information on the Streamlined Sales Tax Project is available on the Internet at **http://www.geocities.com/streamlined2000/**.

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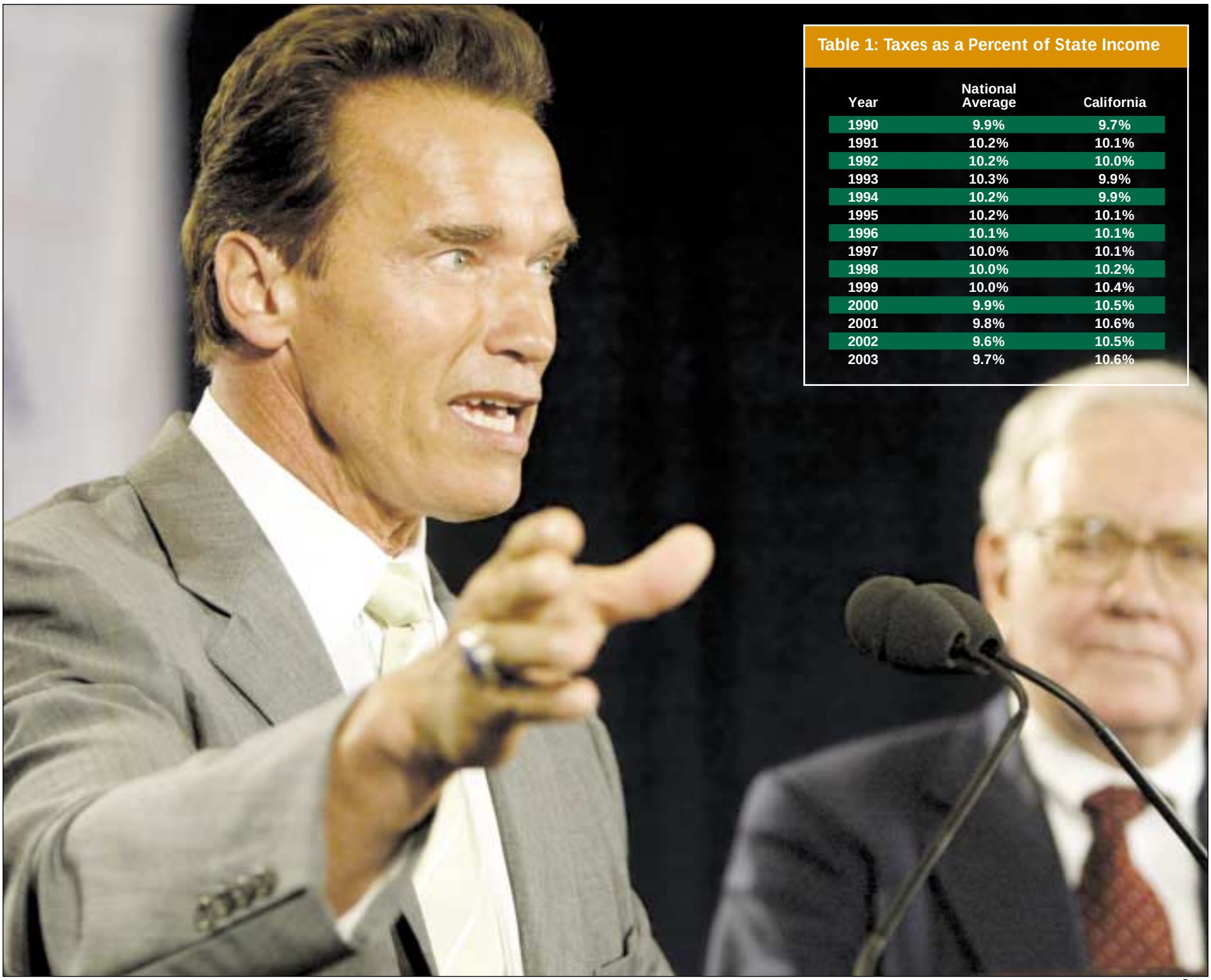

Table 1: Taxes as a Percent of State Income

Year	National Average	California
1990	9.9%	9.7%
1991	10.2%	10.1%
1992	10.2%	10.0%
1993	10.3%	9.9%
1994	10.2%	9.9%
1995	10.2%	10.1%
1996	10.1%	10.1%
1997	10.0%	10.1%
1998	10.0%	10.2%
1999	10.0%	10.4%
2000	9.9%	10.5%
2001	9.8%	10.6%
2002	9.6%	10.5%
2003	9.7%	10.6%

Getty

Governor-Elect Arnold Schwarzenegger speaks at a news conference after meeting with high-profile economic advisors, billionaire investor Warren Buffett (R), and former U.S. Secretary of State George Shultz in Los Angeles, California. Schwarzenegger, a Republican, replaced Gray Davis in the October 7 recall election.

Schwarzenegger

Continued from page 1

and complexity of the tax system. Only Mississippi has a more unfriendly tax climate for business.

In 1990 California had a slightly below-average tax burden (9.7 percent compared to a national average of 9.9 percent). Since then, state/local tax collections have risen much faster than Californians' incomes. Estimated now at 10.6 percent of income, California's state/local taxes are well above the national average of 9.7 percent. (See Table 1.)

Another way to describe California's tax burden is to calculate Tax Freedom Day, the day when Californians have earned enough money to pay off their total tax bill for the year. In 2003, California taxpayers had to work until April 29 to pay their total tax bill, 10 days later than the national average and later than all other states except Connecticut and Massachusetts. (See Table 2.) California taxpayers must work 38 days into the year just to pay their state and local tax bill. At $3,670 per-capita, that bill is the eighth highest in the nation.

With six brackets and a top rate that kicks in at a relatively low $38,291 of income, California has one of the most progressive tax systems in the nation for individuals and small business owners. For the taxpayer with $40,000 of taxable income, California's 9.3 percent state income tax rate is the highest in the nation. For families earning between $43,500 and $307,050, only Montana's tax rate is higher, and over $307,050 of income, only Montana's and Vermont's rates are higher.

Since most small businesses are either S Corporations or partnerships or sole proprietorships, they pay their business taxes at the rates for individuals. That makes California's taxes on small businesses higher than virtually every other state.

Corporate Income Tax

Corporations looking to relocate, or even establish, a business in the West may shy away from California, as the state's 8.84 percent flat rate is the highest corporate tax rate in the West. Nationally, only 10 states have a higher top corporate tax rate than California. In 2002, corporate tax collections in California totaled $152 per capita, the sixth highest per-capita level in the nation.

"[S]tatistically speaking, [California's tax system] is one of the worst in the country for development and economic growth."

California's tax system is a complexity nightmare for corporate taxpayers because it does not conform with the standards and practices adopted within the Federal tax code or most other states. This adds considerable compliance costs for multi-state companies trying to do business in California. The state also enforces both a corporate and individual Alternative Minimum Tax (AMT). It is widely accepted among tax experts that the AMT imposes a level of tax complexity that is disproportionate to the amount of revenue raised. (See "Alternative Minimum Tax Stalks Millions of Taxpayers," page 6.) California is among only five states that have enacted both a corporate and individual AMT (14 states have at least one).

Sales Tax

California's state and local sales tax rate ranges from 7.25 percent to 8.75 percent. Excluding local option sales taxes, California's statutory rate of 7.25 percent is the highest in the country.

The sales tax affects not only consumers, but businesses as well. The state fails to exempt many business items from the sales tax, including manufacturing machinery, office equipment, and farm machinery. For example, on a $100 mil-

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Table 2: Tax Freedom Day by State and Rank Selected Calendar Years, 1990 - 2003

	1990 Tax Freedom Day	1995 Tax Freedom Day	2000 Tax Freedom Day	2003 Tax Freedom Day	Rank in 2003
U.S.	April 20	April 23	April 30	April 19	
Alabama	April 11	April 13	April 16	April 06	48
Alaska	April 21	April 11	April 15	March 30	50
Arizona	April 22	April 25	April 28	April 17	16
Arkansas	April 12	April 16	April 21	April 09	40
California	April 18	April 22	May 08	April 29	4
Colorado	April 20	April 22	May 01	April 21	11
Connecticut	April 22	May 05	May 19	May 09	1
Delaware	April 13	April 17	April 21	April 09	39
Florida	April 16	April 23	April 29	April 15	22
Georgia	April 19	April 22	April 27	April 16	19
Hawaii	April 26	April 20	April 26	April 13	31
Idaho	April 16	April 19	April 25	April 14	25
Illinois	April 23	April 25	May 01	April 20	12
Indiana	April 17	April 19	April 22	April 14	28
Iowa	April 21	April 23	April 22	April 11	35
Kansas	April 20	April 22	April 25	April 13	29
Kentucky	April 15	April 19	April 20	April 09	38
Louisiana	April 13	April 11	April 19	April 07	44
Maine	April 18	April 25	May 04	April 22	9
Maryland	April 19	April 22	April 30	April 17	17
Massachusetts	April 19	April 27	May 11	May 02	2
Michigan	April 21	April 21	April 27	April 17	18
Minnesota	April 24	May 01	May 03	April 23	7
Mississippi	April 11	April 16	April 17	April 07	43
Missouri	April 14	April 18	April 22	April 12	34
Montana	April 17	April 19	April 21	April 09	37
Nebraska	April 18	April 23	April 25	April 12	33
Nevada	April 25	April 30	May 03	April 20	13
New Hampshire	April 15	April 21	April 29	April 15	23
New Jersey	April 25	April 01	May 10	April 27	5
New Mexico	April 18	April 18	April 17	April 03	49
New York	April 30	April 03	May 09	April 29	3
North Carolina	April 15	April 17	April 22	April 13	32
North Dakota	April 15	April 22	April 20	April 11	36
Ohio	April 14	April 19	April 24	April 14	24
Oklahoma	April 13	April 13	April 17	April 06	46
Oregon	April 23	April 21	April 25	April 14	27
Pennsylvania	April 15	April 20	April 25	April 14	26
Rhode Island	April 19	April 23	May 04	April 23	8
South Carolina	April 15	April 17	April 20	April 08	41
South Dakota	April 13	April 19	April 20	April 08	42
Tennessee	April 12	April 13	April 15	April 06	47
Texas	April 20	April 20	April 24	April 13	30
Utah	April 19	April 24	April 26	April 16	20
Vermont	April 23	April 26	May 01	April 17	15
Virginia	April 17	April 19	April 28	April 15	21
Washington	April 30	May 02	May 09	April 27	6
West Virginia	April 14	April 13	April 18	April 06	45
Wisconsin	April 25	April 29	May 02	April 19	14
Wyoming	April 25	April 26	May 09	April 21	10
District of Columbia	May 03	May 02	May 19	May 07	-

lion investment in a new plant and equipment, California's sales tax on machinery could add as much as $9 million in additional costs, depending upon the type of machinery and the plant's location.

High sales tax rates reduce revenue as consumers seek relief via cross-border shopping (neighboring states Nevada and Oregon do not have sales taxes) or making purchases through catalogs and/or the Internet. High sales taxes, then, hurt the state's retailers as well as its consumers.

Conclusion

As the new governor of the state with the country's second-worst business tax system, Schwarzenegger can set the direction and pace for tax reform. Clear priorities should be reducing taxes as a percent of state personal income to the national average or below; flattening a progressive income tax that drives the state's most productive residents to neighboring states; and reducing the corporate income tax. Lowering sales taxes would stem the flow of retail activity to neighboring states.

If he does not fix his state's dysfunctional tax system, Schwarzenegger is likely to fail to fix his state's budget problems. The entire nation will be watching as "The Terminator" grapples with perhaps his most difficult foe ever.

Scott Hodge is president of the Washington, DC-based Tax Foundation.

INTERNET INFO

For more information on California taxes or the work of the Tax Foundation generally, contact Hodge at 202/464-5103, email **hodge@taxfoundation.org**, or Senior Economist Scott Moody at 202/464-5107, email **moody@taxfoundation.org**. Or visit the Tax Foundation Web site at **http://www.taxfoundation.org**.

What Should Arnold Do?

by Chris Mitchell

California's budget crisis dominated the recall campaign, and Gov. Schwarzenegger has promised to deal with the budget before turning to any other issues. A bipartisan report published by Reason Foundation and Performance Institute presents seven reforms and calls for the creation of a bipartisan commission that could be used by Schwarzenegger to implement an economic reform plan immediately. He has already endorsed most elements of the plan, and three of its authors are on his transition team.

"State government budgets are no different than our family budgets; there are basic guiding principles that keep you from going broke," said Matt Fong, former California State Treasurer and coauthor of the plan. "Our *Roadmap to Reform* offers some simple yet powerful principles that our state leaders need to accept, adopt, and apply—or we'll face our bond ratings dropping to junk bond status and even worse fiscal times ahead."

"State government budgets are no different than our family budgets; there are basic guiding principles that keep you from going broke."

MATT FONG
FORMER CALIFORNIA STATE TREASURER

Under the plan, the "Big Five" in Sacramento (the governor and the majority and minority leaders of both legislative chambers) would each appoint two members to a 10-member commission. Then, just 60 days after its creation, the commission would offer a specific 180-day action plan featuring changes to the fiscal practices of California government. The commission, made up of business, academic, and political leaders, could make decisions the legislature has been reluctant to and would function similarly to the federal Base Realignment and Closure Commission, which made politically unpopular decisions regarding the closure of military bases in the early 1990s.

By committing to such a vehicle, the plan's authors said at the time, the winner of the recall would be able to hit the ground running and make the necessary reforms to bring the budget into balance and restore the economic vitality of the state. The Reason Foundation-Performance Institute plan, "A Roadmap to Reform," recommends seven specific reforms:

- Adopt a biennial budget with a bankruptcy-like restructuring plan. Currently 23 states use a two-year budget because it improves oversight and limits the accounting gimmicks that have plagued California.
- Adopt a constitutional spending limit and revenue limit. A spending limit similar to the Gann Spending Limit combined with a revenue limit on tax collection would have largely prevented the present fiscal crisis. The plan also recommends a reserve, or rainy day fund, to offset dips in the economy.
- Overhaul the California tax system. The state's tax system forces some localities to rely on the car tax for up to three-fourths of their revenues; others are dependent upon sales taxes. Re-examining sales taxes, personal income taxes, and car and property taxes in order to construct a less-volatile system is vital for economic investment and long-term growth.
- Create the most jobs-friendly state in the nation, starting with workers' compensation reforms.
- Enact performance-based reforms in state programs. The state has multiple agencies providing duplicate services. These departments should be consolidated and work such as information technology, facility maintenance, purchasing, personnel management, financial management, and administrative support should centralized, with single offices serving all state programs.
- Control personnel costs and empower state employees to improve performance. California will spend more than $22 billion in salaries, wages, and benefits this year. A 10 percent savings can be achieved by eliminating vacant positions, renegotiating egregious raises, and re-assigning personnel.
- Evaluate and improve efficiency through competition and procurement reforms.

Joining Performance Institute and Reason Foundation budget experts Carl DeMaio and George Passantino as authors of the plan were Bill Baker (R), former member of the California State Assembly and U.S. House of Representatives; Kathleen Connell (D), former California State Controller; Matt Fong (R), former California State Treasurer; Bill Jones (R), former California Secretary of State, and Lucy Killea (I), former member of the California State Assembly and State Senate.

Reason Foundation is a nonprofit think tank based in Los Angeles. Performance Institute is a private think tank based in San Diego.

Chris Mitchell is head of media relations for Reason Foundation. He can be reached at 800/582-2245 ext. 3037

INTERNET INFO

The complete Reason Foundation-Performance Institute white paper, *A Roadmap to Reform*, can be found online at **http://www.rppi.org/roadmap.pdf**.

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High Cigarette Taxes Feed Black Market in New York

by Patrick Fleenor

New York State increased its cigarette excise tax rate from $1.11 to $1.50 per pack in April 2002, while New York City dramatically increased its rate from 8 cents to $1.50 per pack in July of that year. Thanks to these hikes, New York City now has the highest cigarette taxes in the country, a combined state and local tax rate of $3.00 per pack.

Consumers have responded by turning to the city's black market and other low-tax sources of cigarettes. During the four months following the tax hikes, sales of taxed cigarettes in the city fell by more than 50 percent compared to the same period the prior year, affecting state and local budgets.

"During the four months following the tax hikes, sales of taxed cigarettes in the city fell by more than 50 percent compared to the same period the prior year, affecting state and local budgets."

Getty

New York has a long history of cigarette tax evasion by residents. Former governor Malcolm Wilson dubbed the city the "promised land for cigarette bootleggers." Over the decades, studies by federal, state, and city officials found high taxes have created a thriving illegal market for cigarettes in the city. That market has diverted billions of dollars from legitimate businesses and governments to criminals.

New York Not Alone

As large state government budget gaps have opened in the past year, lawmakers across the country are turning to cigarette taxes for added revenue. Twenty states raised cigarette tax rates in 2002, and more hikes were on the agenda during state legislative sessions this year.

Proponents of high cigarette taxes portray them as levies that improve public health. Yet those taxes have long been known to have a dark side. Since the first state cigarette taxes were imposed in the 1920s, black markets and related criminal activity have plagued high-tax jurisdictions. Such activity has proven resistant to law enforcement curtailment efforts.

The failure of New York policymakers to consider the broader effects of high cigarette taxes has been a mistake repeated across the country in the stampede to maximize tax revenue. The negative effects of high cigarette taxes in New York provide a cautionary tale that excessive tax rates have consequences.

Patrick Fleenor has been chief economist of the Tax Foundation and senior economist for the Joint Economic Committee of Congress. He is the author of "Cigarette Taxes, Black Markets, and Crime," a February 2003 Cato Institute Policy Analysis.

INTERNET INFO

The full text of Patrick Fleenor's February 2003 Cato Institute *Policy Analysis* is available on the Cato Institute Web site at **http://www.cato.org/pubs/pas/pa468.pdf**.

Justice Department Move Threatens State Revenues

by Stephen J. Entin

The Justice Department's decision to continue to pursue the Clinton-era civil suit against the nation's largest tobacco companies represents poor legal thinking and questionable economic policy, according to analysts at the Institute for Research on the Economics of Taxation (IRET) and Cato Institute. IRET and Cato are think tanks located in Washington, DC.

The lawsuit demands a $289 billion fine from nine tobacco companies. To put that figure in perspective, if successful, the suit would put back into the federal government's coffers more than 80 percent of the 10-year cost of the 2003 tax cut.

The Justice Department's federal tobacco claim is on top of the 25-year $280 billion settlement the companies reached with the states in 1998. President Bill Clinton pushed for a federal lawsuit, which IRET labeled at the time "taxation through litigation instead of legislation." That suit was apparently laid to rest, but has arisen undead and with impressive fangs.

"This lawsuit is a loser in many respects," said attorney Robert Levy at a forum on the case held earlier this year at Cato. "It is based upon bad law and is certainly bad public policy. The American public, voters, and juries need to know our legal system is rapidly becoming a tool for extortion."

"This lawsuit is a loser in many respects. It is based upon bad law and is certainly bad public policy. The American public, voters, and juries need to know our legal system is rapidly becoming a tool for extortion."

ROBERT LEVY
CATO INSTITUTE

A former Justice Department official involved in the initial examination of the case said the matter is not politically motivated. He noted it was permanent Justice Department staff—not political appointees—who recommended pursuing the charges.

Bad Economics

Legal and political considerations aside, the Justice Department action is ill-considered as economic policy.

- The Justice Department claim would act like a selective excise tax on cigarette consumers and producers. Since the companies cannot print money or operate at a loss, the entire fine (if the matter survives a trial) would have to be paid by several tens of millions of cigarette smokers (who would pay higher retail prices), tobacco farmers (lower commodity prices), company employees (lower wages), and shareholders (lower dividends).
- Although the tobacco tax, or its "fine" equivalent, is widely regarded as falling on consumption, not income, increasing it would still be bad for the economy. Excise taxes are bad tax policy; because they fall on a single product, they distort economic behavior.
- Excise tax revenues drop if fewer packs are sold. The fine, however, would not be based on the number of packs sold. As the penalty-induced price hikes caused people to smoke less, the companies would still owe the full fine and would have to boost prices all the more to keep paying Washington.

The Justice Department may not care that several states have spent themselves into financial holes lately. But it should note that fining tobacco companies would reduce cigarette sales volume and state tobacco tax revenues. The states have already started down that road by imposing major tobacco tax hikes in the last year to fight their budget deficits. They are finding that cigarette sales—at least, legal sales excluding smuggling—are much more responsive to predatory taxation than they assumed.

Stephen J. Entin is president and executive director of the Institute for Research of the Economics of Taxation in Washington, DC. His email address is **sentin@iret.org**.

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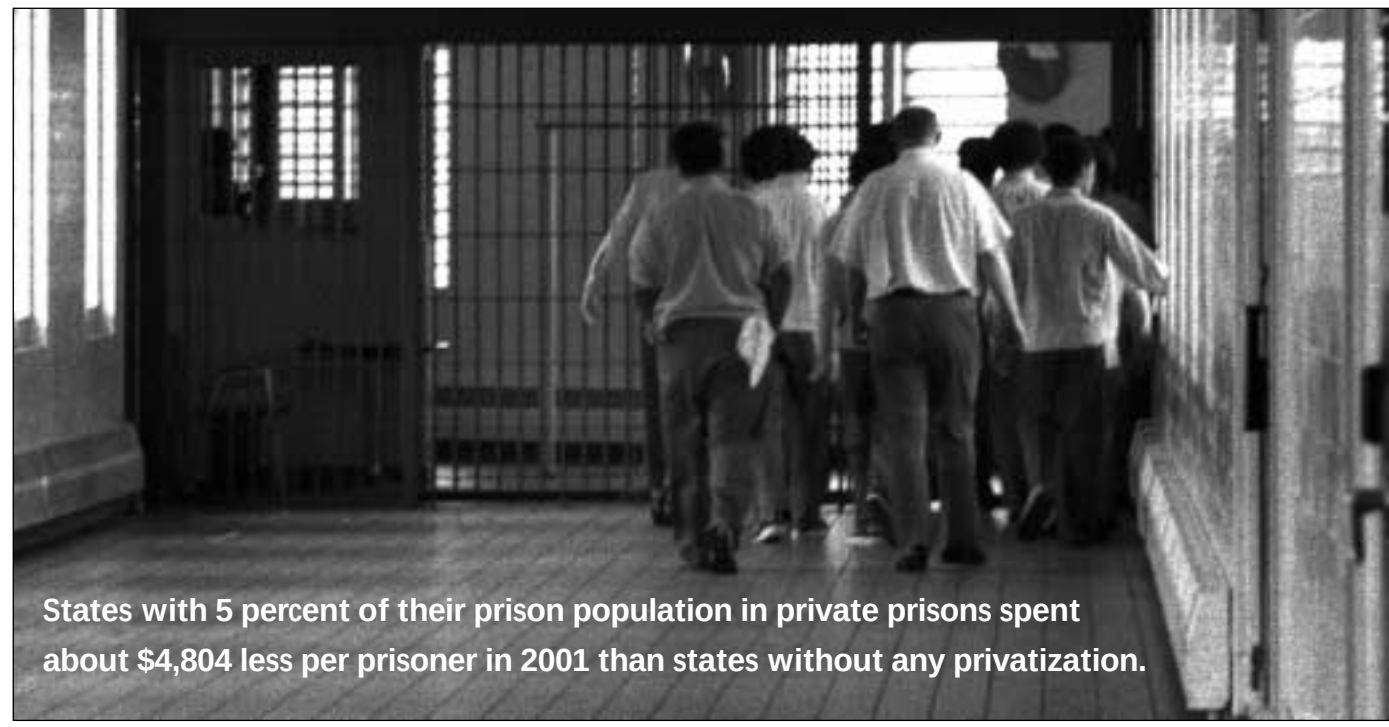
Private Prisons Save Money, Boost Productivity, Studies Find

by Geoffrey F. Segal

In a get-tough-on-crime move nearly a decade ago, Florida passed in 1995 a law requiring all prison inmates to serve at least 85 percent of their sentences. Since then, the amount of time most inmates spend behind bars in the Sunshine State has increased dramatically, putting privatization on the table for Florida policymakers.

Longer sentences mean more crowded prisons and a bigger market for the private prison industry, said Alan Duffee, executive director of the Correctional Privatization Commission that oversees Florida's five private prisons. "That has been an effect of [the 85 percent law]," Duffee said. "We have fewer inmates (going) out than coming in."

According to the Los Angeles, California-based Reason Foundation, new research shows private prisons are "a viable alternative for addressing state budget and cost concerns"—not only in Florida, but across the United States.



States with 5 percent of their prison population in private prisons spent about $4,804 less per prisoner in 2001 than states without any privatization.

Zuma Press

Privatization and Competition

Three-fifths of all U.S. states host private prisons; most of them contract with the companies to house prisoners. Studies show privatization can result in savings in the range of 5 to 20 percent. Adding to that body of research, two new studies take a slightly different approach to estimating the cost savings associated with prison privatization.

By measuring an entire department's spending rather than just a particular prison's spending, the studies account for the cost savings that result when public prisons respond to private competition.

"Three-fifths of all U.S. states host private prisons ... Studies show privatization can result in significant savings, in the range of 5 to 20 percent."

In an August 2003 report, two professors at Vanderbilt University analyzed whether the use of private prisons by state correctional departments had any effect on the rate of growth in the operating budgets of state corrections systems. While anecdotal evidence existed in Texas and Arizona, a systematic analysis had never been done.

Using data for 1999-2001, the study found states that utilized private prisons had considerably more success in keeping their total public corrections spending under control than states with no private prisons. During the period studied, the daily cost of housing prisoners grew 8.9 percent more slowly in states with private prisons than in states without them.

In 2001, according to the study, states without private prisons spent $445 million a year on average for their corrections systems. The researchers projected the average state in that group could save $20 million a year in public prison operating costs simply by introducing competition and prison privatization. Further savings would be achieved through the actual operation of the private prisons themselves.

Importantly, the Vanderbilt University researchers also found that turning over to the private sector even the smallest of prison populations results in big savings. States with less than 5 percent of their prison population in private facilities experienced a 12.5 percent increase in expenditures over the period studied, versus an 18.9 percent increase for states without private prisons. States that had turned over larger shares of their prison populations to private management experienced even greater savings: Expenditure growth was just 5.9 percent for this group over the period studied.

In a second study, researchers at the Rio Grande Foundation in New Mexico compared per-prisoner department of corrections budgets across 46 states. The study uses the percentage of prisoners under private management as its measurement of the extent of privatization in each state. The author controlled for factors that affect a corrections department's per-prisoner cost: market wage for prison employees, prison crowding, and labor conditions, for example.

Holding other factors constant, the Rio Grande study found states with 5 percent of their prison population in private prisons spent about $4,804 less per prisoner in 2001 than states without any privatization.

As the extent of privatization increases, so do savings. New Mexico, for example, has 45 percent of its prison population under private management; it spent $9,660 less per prisoner in 2001 than did counterpart states with no privatization. New Mexico has gone farther down the prison privatization road than any other state—saving $51 million in 2001 alone, according to the Rio Grande study.

A Compelling Case

While the Vanderbilt study looked at privatization's effect on the growth of prison expenditures over time, the Rio Grande study was more a snapshot of how privatization affected corrections spending in 2001. While the two studies didn't measure the same things, the results are complementary and make a compelling case.

States that utilize competition and privatization for corrections save money. The more a state competes and privatizes, the more money it saves.

The experience of competition and privatization has been well documented across a broad range of services. These two studies represent another feather in the cap for privatization, and a continued solution for the state of Florida.

Geoffrey F. Segal is director of privatization and government reform policy at Reason Foundation and a research fellow at the Davenport Institute at Pepperdine University's School of Public Policy. His email address is **geoffrey.segal@reason.org**.

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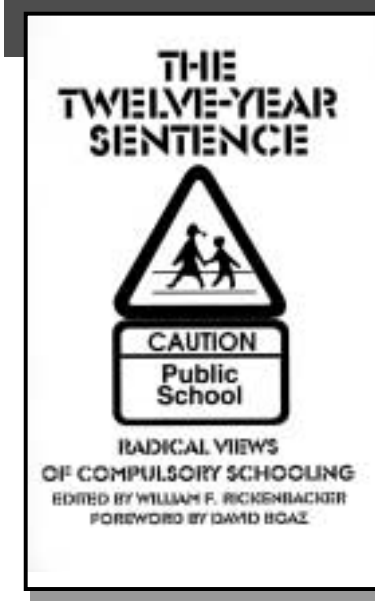

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Washington

Continued from page 1

balanced budget was predicted for the 2004 fiscal year. Neither sleight-of-hand nor tax increases accounted for the improvement ... but policymakers' successful implementation of a new approach to budgeting.

Innovative Solution

Conventional thinking says lawmakers planning next year's budget must look at the existing budget, adjust for inflationary and caseload increases, and find ways to raise taxes or cut services to maintain the status quo. But the new budget model developed by Washington Governor Gary Locke (D) rejected such conventional thinking.

Bob Williams, president of the Olympia-based Evergreen Freedom Foundation (EFF), noted, "The governor's budget team actually implemented recommendations EFF has offered over the past decade. Serious efforts were finally made to reduce costs, eliminate non-essential services, and prioritize spending. This was a great first step."

Locke opted to balance the budget within forecasted revenues, an "innovative" approach that addressed the projected budget deficit. The four-step effort has laid the foundation for further budget reforms in the state. Locke's team:

- Identified the core functions of government.
- Identified the outputs desired from the core functions.
- Evaluated a wide range of purchase strategies to determine which would achieve the desired results.
- Prioritized all agency programs into "High," Medium," or "Low" priority.

Surprising even his own party and past stalwart supporters, Locke remained committed to his new budget model, allowing the state's Republican Senate to push through a balanced budget without new general taxes. Locke's relationship with the Speaker of the House, Democrat Frank Chopp, frayed.

"By the end of the legislative session, not only had the governor and state legislature wiped out the 2003 deficit, but a balanced budget was predicted for the 2004 fiscal year."

But Locke's commitment to his approach, and his desire to achieve bipartisan support for the effort, won him praise from both sides of the aisle. Olympia lawmaker Gary Alexander, the ranking Republican member of the House Capital Budget Committee, was among Locke's advocates. "We have the opportunity to make meaningful changes in the way government does business," Alexander said. "If we don't work together, accept our responsibility, and rebuild the peoples' trust, the cycle will just repeat itself."

Washington State Governor Gary Locke (D) used four steps to balance the budget:

- **Identify the core functions of government.**
- **Identify the outputs desired from the core functions.**
- **Evaluate a wide range of purchase strategies to determine which would achieve the desired results.**
- **Prioritize all agency programs into "High," Medium," or "Low," priority.**

Getty

Core Functions Established

Locke and his budget team defined the core functions of Washington state government in terms of 10 goals they wanted to achieve. They sought to identify measurable outcomes and prioritized agency programs based on their ability to help achieve the 10 goals. State agency heads were enlisted in the process, asked to articulate their core missions and prioritize their programs and budgets accordingly. A model budget was drafted to allocate forecasted resources according to the priorities identified.

Four key questions guided the governor's effort:

1. How much money does the state have?
2. What does the state want to accomplish?
3. What is the most effective way to accomplish the state's goals within existing revenue?
4. How can/will the state measure its progress toward those goals?

The governor and his staff decided the core functions of government could be accomplished by meeting the following 10 goals:

- Increase student achievement in elementary, middle, and high schools.
- Improve the quality and productivity of the workforce.
- Deliver increased value from post-secondary learning.
- Improve the health of Washingtonians.
- Improve the condition of vulnerable children and adults.
- Improve the economic vitality of businesses and individuals.
- Improve the mobility of people, goods, information, and energy.
- Improve the safety of people and property.
- Improve the quality of Washington's natural resources.
- Improve cultural and recreational opportunities throughout the state.

While EFF's Williams doesn't agree with many of the governor's 10 goals for government, he is "elated with the sensible process [Locke's] office used to develop them. They asked the right questions, developed a logical process to determine the answers, and prioritized spending within forecasted revenue accordingly. They created a new set of tools that can and should be used by both political parties."

According to Williams, "Legislators now have a legitimate place to begin the debate and either ratify or modify these 10 functions. That's the hard part because, once the legislature has determined the state's core functions, they will serve as the litmus test for the hundreds of agencies, boards, commissions, and programs currently funded. If an agency or program is not advancing one of the agreed-upon core functions of government, it should be eliminated.

"Now is the time for standing committees to make this review and set the state's priorities for the next budget," Williams continued. "It's time to see if all the programs agencies are currently engaged in can be justified as core functions of the state. Then legislators need to prioritize agency programs and activities using agency mission statements, goals, and objectives."

According to Locke, that process is already underway. "We [in the administration] have already begun a complete re-examination of the size and scope of state government. We have several of our agency directors working in a multidisciplinary fashion. This is not looking at their own agencies, but really looking at other agencies and just looking at the entire scope of state government.

"Locke and his budget team defined the core functions of Washington state government in terms of 10 goals they wanted to achieve."

"Working together—Democrats and Republicans, government and business—I am confident that we can continue to lay a solid foundation for economic vitality and future prosperity for our state," Locke added.

"The next test is if legislators will institutionalize this process and build on it," said Williams.

John Skorburg is managing editor of Budget & Tax News. *His email address is* **skorburg@heartland.org**.

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Nevada

Continued from page 1

that the state fund education ... and it also requires a two-thirds supermajority in each house to pass tax increases. While the Governor was able to persuade the legislature to pass the education budget earlier in the Spring, he could not garner enough votes to raise the taxes to pay for it.

After two special sessions, Guinn sued the legislature in the state supreme court, asking for an order to force the legislature to fund education.

"(T)he Legislature has failed to comply with the mandatory, non-discretionary provisions of the Nevada Constitution requiring it to fund education and balance the budget," Guinn said in a brief filed with the court.

On July 10, by a 6-1 vote, the state supreme court went one step further, ordering the legislature to pass a tax increase by a simple majority vote instead of the two-thirds required by the constitution. It reasoned, among other things, that the substantive education provisions of the state constitution should be given more weight than the procedural supermajority requirement.

"The Court erased an entire clause of the state's constitution—a clause added by the people in two separate elections, by overwhelming majorities."

TIM SANDEFUR
PACIFIC LEGAL FOUNDATION

"The two-thirds supermajority provision, as passed, created the potential for an absolute budgetary stalemate in the Legislature," the majority ruled in *Guinn v. Legislature*. "[J]udicial resolution of the constitutional conflict was necessary, so that the Legislature could perform its constitutionally mandated duties.

"To avoid an impasse harmful to public education," the court continued, "we held that the Legislature could suspend the supermajority rule in favor of a vote by simple majority ... in order to fulfill its obligations to fund education and balance the budget."

Also in a 6-1 ruling, the court declined on September 17 to rehear its decision.

Carole Vilardo, executive director of the Nevada Taxpayers' Association, was disappointed with the court's decision. "Denying the rehearing was not a surprise to me, but it was a disappointment, particularly in light of the fact that in the original decision they provided a remedy that had not been asked for."

Dissenting Opinion

Justice A. William Maupin issued the lone dissent to the majority's ruling. "(T)he people of this state had every right to make it more onerous for the Legislature to create new revenue streams for the operation of government," he wrote.

Tim Sandefur, a fellow in the College of Public Interest Law at the Pacific Legal Foundation, which filed an *amicus curiae* brief in the case, agreed with Maupin: "The Court erased an entire clause of the state's constitution—a clause added by the people in two separate elections, by overwhelming majorities."

John Eastman, director of the Claremont Institute Center for Constitutional Jurisprudence and professor of law at Chapman University School of Law, questioned the court's conclusion that the Nevada constitution contains substantive education guarantees. "The Nevada Constitution mandates that the state support one school in each district for six months per year—a minimal constitutional obligation that was easily met by the existing funding." An attorney, Eastman represented 15 legislators who petitioned the Nevada Supreme Court to re-hear the case.

The sufficiency of education funding is the purview of the legislature, said Eastman, not the courts. "Prioritizing between education and other governmental services is the essence of legislative decision-making," he explained.

Sandefur agreed with Eastman's separation of powers concerns. "There are at least four centuries of traditional common law protections for the Legislature's right to decide when to tax or not to tax the people," he noted. "But rather than reining in their spending appetites, Governor Guinn and the majority of the State Legislature wanted to tax the people even more. When they found that they didn't have the votes, they simply decided to change the rules, and the Court went along. The whole point of having a Legislature and Constitutional procedures is so that you don't have arbitrary rule."

Dangerous Precedent

The legislators represented by Eastman sought reconsideration of the decision because of the dangerous precedent its ruling could set for Nevada and other states.

In California, which has education and supermajority constitutional provisions similar to Nevada's, the state superintendent of public instruction has already threatened a similar lawsuit because of the budget stalemate in Sacramento.

"I cannot in all good conscience stand by and watch political conflict disrupt the education of the children of California," said Superintendent Jack O'Connell. "While the circumstances in Nevada were clearly different than what we are facing here in California, the heart of the argument that funding education ought to take precedence over a procedural requirement rings true."

California managed to pass a budget before O'Connell's threatened lawsuit commenced, but the threat gave credence to concerns that the precedent set in the Nevada case could extend beyond that state's borders.

"Usually, when government does something rash, the proper solution is a political campaign. But in this case, the non-political branch made a sudden and undemocratic change in the clear governing procedure of the state, and in the process violated Nevadans' right to have their votes count and to have their Constitution obeyed," commented Sandefur.

Roll Call

While Governor Kenny Guinn was able to persuade the legislature to pass his education budget, he could not garner enough votes to raise the taxes to pay for it. After two special sessions, Guinn sued the legislature in the state supreme court.

Tax increases may not be the only unpleasant outcome from the Nevada supreme court's decision. Eastman fears something more important is at stake: "Constitutional government, and the right of the people to government by consent, is in peril."

Chris Atkins is director of tax and fiscal policy for the American Legislative Exchange Council.

INTERNET INFO

The full text of the Nevada supreme court's decision in *Guinn v. Legislature* is available through *PolicyBot*. Point your Web browser to **http://www.heartland.org**, click on the PolicyBot icon, and search for document **#13337.**

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Adam Smith on Taxes

by Tom Walton

Although he lived in the 1700s, Adam Smith is still known and revered today for his work on free-market economics, including taxation. If federal, state, and local governments would follow Smith's policy prescriptions, more economic wealth would be created. According to many economists today, Smith remains the best tax economist of all time.

Adam Smith is best known for the first theorem of welfare economics—an unfettered market will automatically, as if by an "invisible hand," allocate a nation's resources in the most efficient manner possible. Smith's theories of taxation follow from that principle. Taxes should be levied only to support a limited government and should satisfy four maxims: equity, transparency, convenience, and efficiency. According to Smith, nations that maintain free markets and limited taxes will maximize their wealth.

Smith believed taxes should support four legitimate functions: national defense, justice, universal education, and "good roads and communications." All four functions are "beneficial to the whole society and may therefore, without any injustice, be defrayed by the general contribution of the whole society." He added that user fees should help to cover roadway expenses, and that the rich should pay for their children's education. He thus anticipated both social externalities and user-pay principles. Today, general revenues support many government programs that are not justified by these principles; Smith would surely view them as unwarranted interventions.

"Taxes should be levied only to support a limited government and should satisfy four 'maxims': equity, transparency, convenience, and efficiency."

Four Tax Maxims

The first of Smith's tax maxims, *equity*, reflects his belief that the wealthiest benefit most from government and can most afford to pay. "The rich should contribute to the public expense not only in proportion to their revenue," Smith believed, "but something more than in that proportion." Equity, according to Smith, requires progressive taxation. That principle is firmly embedded in the U.S. tax code today.

Smith's second maxim is that "the tax which each individual is bound to pay ought to be certain and not arbitrary" and "clear and plain"—that is, *transparent* to everyone. Transparency would help prevent unscrupulous "tax gatherers" from undermining trust in the system. Today's U.S. tax code falls far short of Smith's "clear and plain" maxim. International economists view the creation of transparent rules for taxation as one of the most significant economic policy objectives for emerging economies.

The third maxim is *convenience*. "Every tax," said Smith, "ought to be levied at the time, or in the manner, in which it is most convenient for the contributor to pay it." Smith spoke of tax "simplification" in this context and said Britain's duties on customs could benefit from "the same degree of simplicity, certainty, and precision, as those of [an] excise" on domestic consumption. U.S. taxes hardly meet this test. According to the IRS, taxpayers devoted 3.21 billion hours and $18.8 billion in 2000 complying with the federal income tax.

Smith's fourth maxim is *efficiency*: "Every tax" should be devised so as "both to take out and keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of a state." This requires keeping administrative costs and economic distortions to a minimum. Economic distortions might "obstruct the industry" of business people and thereby prevent them from giving "employment to great multitudes" of people. The most efficient tax, according to Smith, would leave "the annual produce of the land and labor of society, the real wealth and revenue [of a nation] the same as before."

The importance of Smith's insight to the U.S. economy is illustrated by Martin Feldstein of the National Bureau of Economic Research, who estimates that a 10 percent across-the-board reduction in all federal income tax rates would lose about $22 billion per year in federal revenues, while increasing economic efficiency by $40 billion per year.

What Should Be Taxed

Smith applied these maxims to four types of taxes: taxes on the rents from land; the wages of labor; the profits of capital; and taxes that would fall "indifferently" or equiproportionately on all three factors of production.

Smith believed taxes on rents from unimproved land were the most efficient because unimproved land was not augmentable and therefore could be taxed without affecting its supply. However, he was not sure how to isolate the rents from unimproved land from those from improvements resulting from "the attention and good management of land."

Subsequently, a nineteenth century economist, Henry George, conceived of a single tax on land, essentially sidestepping the difficulty of isolating unimproved land. As the first Nobel Laureate in economics, Paul Samuelson, noted: "Actually, much of the land we use has been augmented by man: it *has* been drained, filled, and fertilized by investment effort quite like that which builds machines and plants." (Emphasis in original.)

Smith was most critical of taxes on wages and profits. Both diverted resources from wealth-creating activities, he pointed out, and raised the prices of manufactured goods by more than the amount of the tax. Taxes on the profits of "stock" were destructive of wealth creation because "stock cultivates land; stock cultivates labor," and a tax on profits diminishes both "the rent of land and the wages of labor." These considerations remain relevant today as politicians debate the taxation of dividends and capital gains.

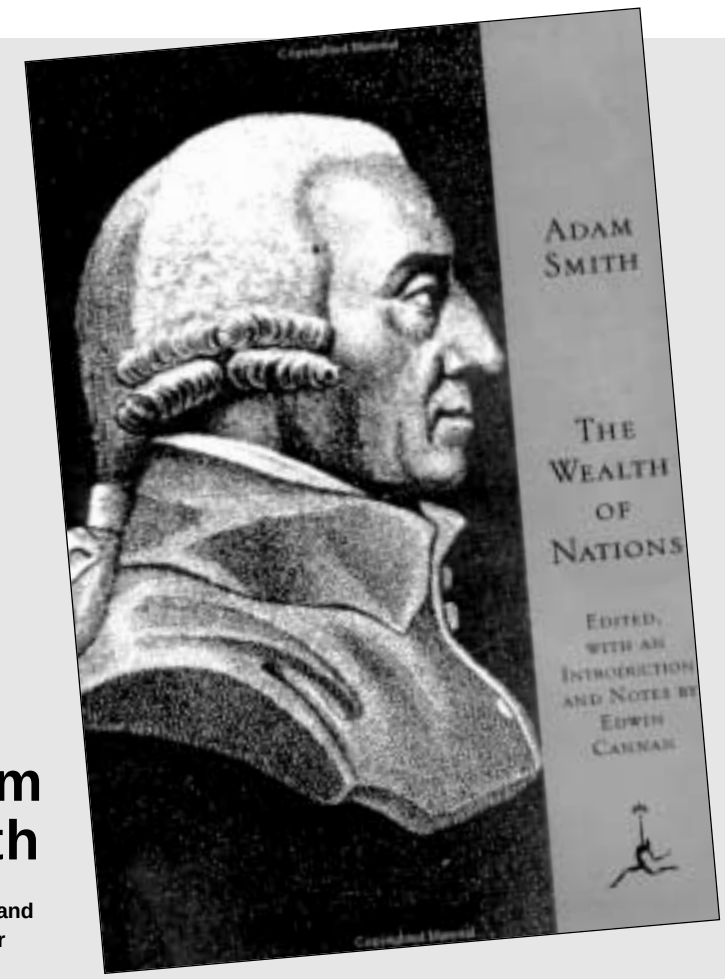
Smith believed taxes that fall indifferently on all three factors of production were highly efficient. These include poll or "capitation" (head) taxes and broadly based taxes on consumption. However, Smith rejected poll taxes as extremely regressive and excluded basic necessities such as wooden shoes and vegetables from taxable consumption. He had mixed emotions over taxing beer. Numerous "exemptions" reduce the efficiency of consumption taxes today.

Smith opposed targeted taxes on specific industries and regions because they "always alter, more or less, the natural direction of national industry, and turn it into a channel always different from, and generally less advantageous than that in which it would have run of its own accord." He noted that Great Britain's uniform system of taxation, "this freedom of interior commerce," was a "principal cause" of its "prosperity." America's founders, many of whom read *The Wealth of Nations*, inserted an Interstate Commerce Clause into the Constitution.

Smith opposed Britain's customs duties because they distorted trade, and because they were so high they reduced consumption and increased smuggling so much that a lower tax would generate greater revenues. Shades of Arthur Laffer!

Most of Smith's theories of taxation are valid and relevant to the debates over tax reform today. Limited taxes that are equitable, transparent, convenient, and efficient, combined with an "unfettered market," are still essential to maximizing the wealth of a nation.

Tom Walton is an economist with General Motors in Detroit and a member of the Board of Directors of The Heartland Institute.



Adam Smith

Economist and Philosopher
1723 - 1790

Adam Smith was born in Kirkcaldy, Fife, Scotland in 1723. In 1751 he was appointed professor of logic at Glasgow University, delivering lectures in ethics, rhetoric, jurisprudence, and political economy. In 1759 he published *The Theory of Moral Sentiments*.

He moved to London in 1776, where he published *An Inquiry into the Nature and Causes of the Wealth of Nations*, which examined in detail the consequences of economic freedom. It covered such concepts as the role of self-interest, the division of labor, the function of markets, and the international implications of a laissez-faire economy. *Wealth of Nations* established economics as an autonomous subject and launched the economic doctrine of free enterprise. In 1778 Smith was appointed to a post of commissioner of customs in Edinburgh, Scotland. He died there on July 17, 1790, after an illness.

INTERNET INFO

The full text of *The Theory of Moral Sentiments* is available on the Internet at the Liberty Fund's Library of Economics and Liberty Web site, **http://www.econlib.org/library/Smith/smMS.html**. *Wealth of Nations* is online at **http://www.econlib.org/library/Smith/smWNtoc.html**.

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The Terrible Cost of Government

by Hon. Ron Paul

According to Americans for Tax Reform, Americans worked until mid-July this year to pay their whopping bills to the government. July 11 was "Cost of Government Day" for 2003, the date when the average American has worked enough in the calendar year to pay for government at the federal, state, and local levels. In other words, most Americans turn over more than half of everything they make to government—in taxes, fees, and regulations that increase the price of goods and services. For high-income individuals, the percentage can be much more than half.

The good news for Americans is that the Cost of Government Day is behind us for the year. The bad news is that the day keeps falling later and later, in fact 17 days later than in 2000. This is due largely to the rapid growth in federal spending in recent years. This relentless growth has increased the burden of government faster than national income has risen. The result is that taxpayers are left with less money to spend, save, or invest, while the legitimate private economy staggers under the weight of a growing federal leviathan.

Only during World War II—a momentous event requiring a huge mobilization of men, machinery, and supplies—did the federal government consume more of the nation's productive economy than it does now. The federal government simply should not be devouring 40 percent of the nation's gross domestic product!

For those who desperately want to see the size and scope of the federal government reduced, the first Bush term is a very serious disappointment. Spending levels are approximately 22 percent higher than when Bill Clinton left office. Health care spending has increased 36 percent in three years, education spending has increased 26 percent, and "community and regional development" spending, which includes boondoggles like HUD, has increased 31 percent. These purely domestic spending increases cannot be excused by terrorism or the war in Iraq.

"Today's political process is nothing more than a street fight between various groups seeking to vote themselves other people's money."

Of course both Congress and a succession of Presidents are responsible for the spending mess. The President can set a tone for fiscal restraint or indulgence, and can veto spending bills if he has the political will to do so. Congress, however, actually crafts the laughable federal "budget" and appropriates the money, so the ultimate blame for spending increases must be accorded members of the House and Senate.

It's easy to talk about smaller government, but few actually vote against the 13 annual appropriations bills that fund so many wasteful and unconstitutional departments, agencies, and programs. There are simply too many special interests counting on the money contained in the appropriations bills, and those same interests will take their campaign contributions elsewhere if a congressman fails to play the game.

The American people are also responsible for the growth in government, however. We have allowed our constitutional republic to deteriorate into a virtually unchecked direct democracy. Today's political process is nothing more than a street fight between various groups seeking to vote themselves other people's money. Individual voters tend to support the candidate that promises them the most federal loot in whatever form, rather than the candidate who will uphold the rule of law.

As the brilliant writer and professor Thomas Sowell said, "If you have been voting for politicians who promise to give you goodies at someone else's expense, then you have no right to complain when they take your money and give it to someone else, including themselves."

Congressman Ron Paul (R) represents the 14th District of Texas.

Congressman Ron Paul

Ron Paul, M.D. is a premier advocate for liberty in politics today. First elected to Congress in 1976, Rep. Paul is a leading spokesman in Washington for limited constitutional government, low taxes, free markets, and a return to sound monetary policies based on commodity-backed currency. He is known among his colleagues in Congress and his constituents for his consistent voting record in the House of Representatives: Dr. Paul never votes for legislation unless the proposed measure is expressly authorized by the Constitution.

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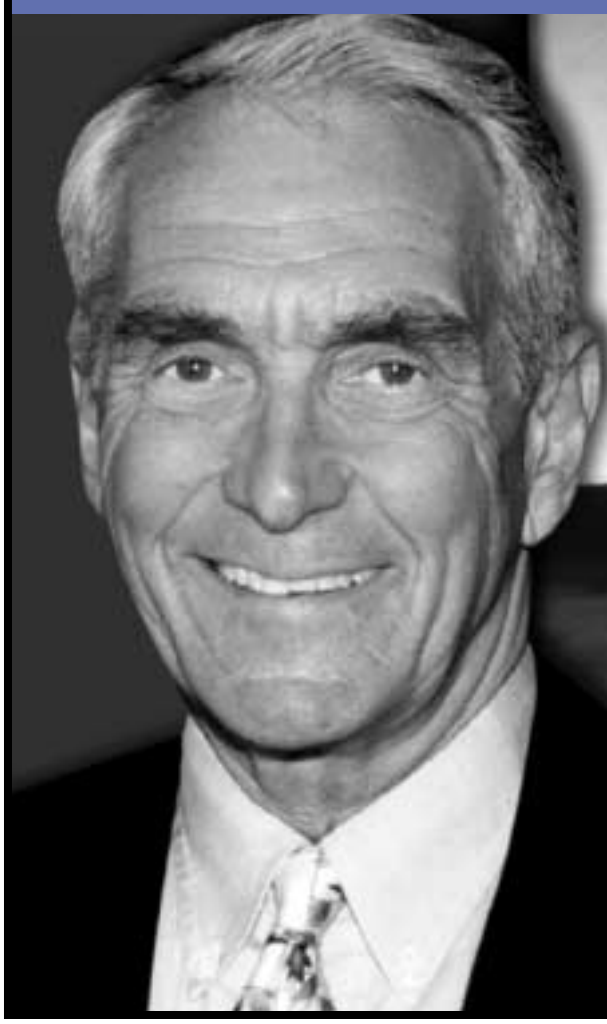

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